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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1932

No. 163

ATLANTIC CITY ELECTRIC COMPANY,
PETITIONER,

vs.

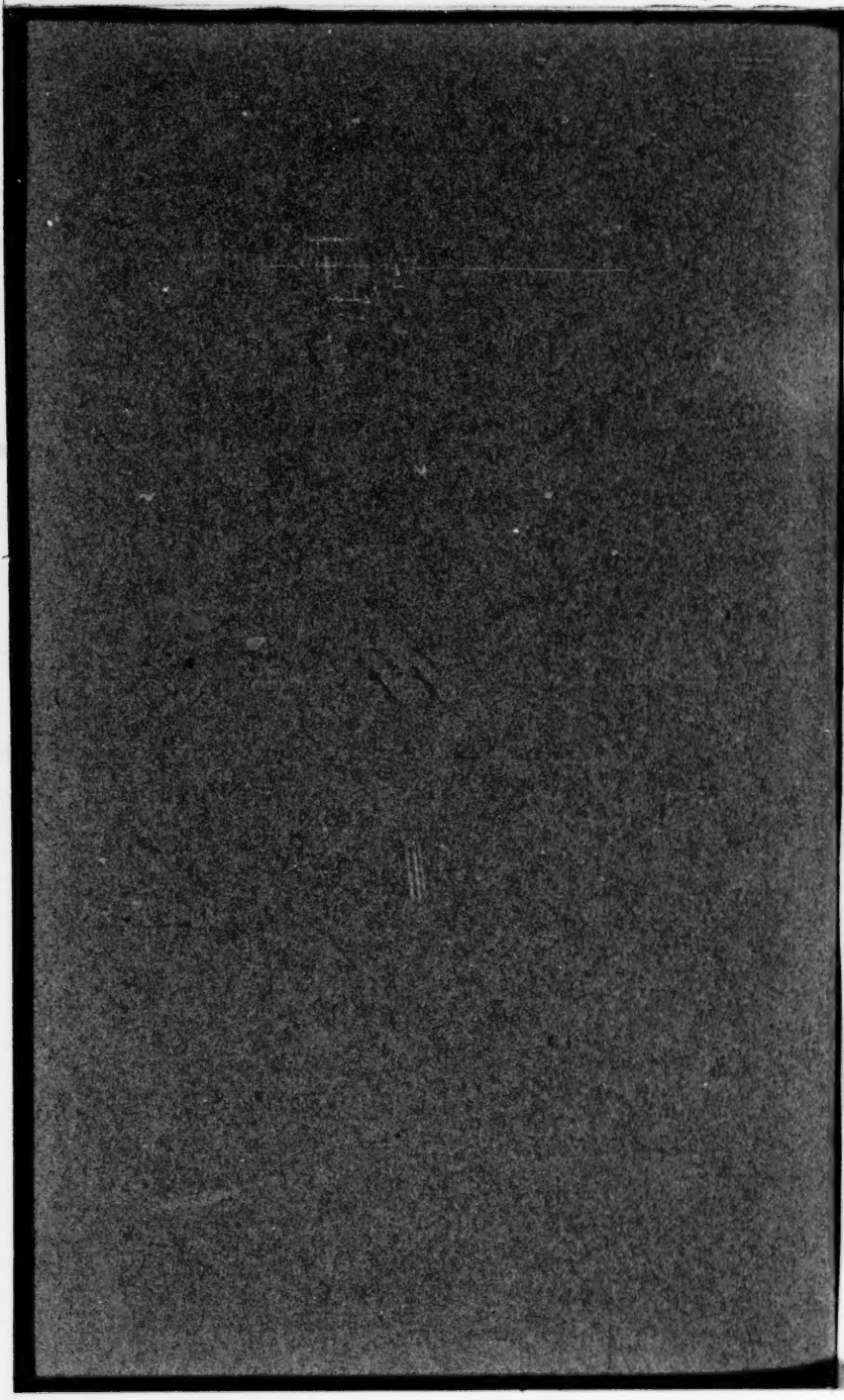
COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 17, 1932

CERTIORARI GRANTED OCTOBER 10, 1932

(36,860)



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BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 17871

ATLANTIC CITY ELECTRIC CO.

vs.

COMMISSIONER OF INTERNAL REVENUE

For taxpayer, C. Kelsey, Esq.; for Commissioner, Eugene Meacham, Esq., C. E. Lowery, Esq. Nov. 9, 1929, Mr. Black.

DOCKET ENTRIES

1926.

June 24. Petition received and filed.
" 26. Copy of petition served on solicitor.
" 26. Notification of receipt mailed taxpayer.
Aug. 25. Answer filed by G. C.
Sept. 2. Copy of answer served on taxpayer. Gen. cal.

1928.

July 10. Hearing set Nov. 21, 1928.
Nov. 13. Motion to amend petition filed by taxpayer, amendment tendered.
" 14. Copy of motion served on taxpayer. Assigned to 11-21-28.
" 14. Copy of motion served on G. C.
" 21. Hearing had before Mr. Milliken on merits. Taxpayer's brief in 60 days. Consolidated with 17872.
" 27. Transcript of hearing 11-21-28 filed.

1929.

Jan. 19. Brief filed by taxpayer.
" 19. Motion for extension to Jan. 30, 1929, to file brief filed by G. C. 1-22-29. Granted.
" 29. Brief filed by G. C.
Mar. 26. Findings of fact and opinion rendered, Mr. Milliken. Judgment will be entered under rule 50.

1929.

Sept. 20. Notice of settlement filed by G. C.
" 23. Hearing set Oct. 16, 1929, under rule 50.
Oct. 7. Motion to postpone hearing from Oct. 16, 1929, to period of 60 days, filed by taxpayer.
" 11. Order extending time to 12-13-29 within which petitioner may file a proposed computation under rule 50, and that proceeding be placed on day calendar of 12-18-29, entered.
Dec. 10. Motion for continuance of 60 days for hearing and like extension for filing alternative recomputation, filed by taxpayer.
" 13. Order enlarging time for filing petitioner's proposed computation under rule 50 to Feb. 14, 1930; and that proceeding be continued to day calendar of 2-19-30, entered.

[fol. 2]

1930.

Feb. 11. Motion to postpone hearing for 30 days and like extension for filing alternative recomputation filed by taxpayer. 2-12-30. Granted for hearing Mar. 19, 1930.
Mar. 13. Motion to postpone hearing for 30 days and like extension for filing alternative recomputation, filed by taxpayer.
April 4. Motion for leave to file amended settlement under rule 50 and to continue hearing for 30 days, filed by G. C. Amended notice of settlement tendered.
" 4. Granted.
" 25. Consent to settlement filed by taxpayer.
" 30. Decision entered, Logan Morris, Div. 14.
June 25. Motion to withdraw exhibits filed by taxpayer.
July 4. Motion to withdraw exhibits filed by taxpayer.
Oct. 25. Petition for review to U. S. Circuit Court of Appeals, 2nd Circuit, with assignments of error filed by G. C.
" 31. Proof of service filed (2).
Dec. 23. Motion to extend time to Feb. 25, 1931, to settle and transmit record, filed by G. C.
" 23. Order for extension of time to 2-25-31 to settle and transmit record, entered.

1931.

Feb. 24. Motion for extension to April 25, 1931, to settle and transmit record, filed by G. C.

" 25. Order for enlargement of time to prepare evidence and deliver record sur petition for review entered. Extended to Apr. 25, 1931.

Apr. 22. Motion for extension to June 25, 1931, to settle and transmit record, filed by G. C.

" 23. Order enlarging time to June 25, 1931, for preparation and transmission of evidence sur petition for review, entered.

June 22. Motion for extension to Aug. 25, 1931, to settle & transmit record, filed by G. C.

" 23. Order of extension to Aug. 25, 1931, to settle & transmit record, entered.

Aug. 15. Motion for extension to Oct. 26, 1931, to settle & transmit record, filed by G. C.

" 18. Order extending time to Oct. 26, 1931, to settle & transmit record, entered.

Oct. 3. Præcipe with proof of service thereon filed.

" 24. Order entered enlarging time for transmission and delivery of the record to November 26, 1931.

Nov. 21. Order entered enlarging time for transmission and delivery of the record to Dec. 31, 1931.

Nov. 27. Stipulation that decision in this case shall apply to docket 17872, filed.

[fol. 3] BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

PETITION—Filed June 24, 1926

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, IT:CR:D-60D-TE, dated April 26, 1926, and as a basis of its proceedings alleges as follows:

1. The petitioner is a corporation of the State of New Jersey with principal office at No. 30 Church Street, New York, N. Y.

2. The notice of deficiency (a copy of which is attached and marked "Exhibit A") was mailed to the petitioner on April 26, 1926.

3. The taxes in controversy are income and profits taxes for the calendar years 1917, 1918, and 1919, and for the amounts of $9,717.54, $7,482.78, and $38,942.80, respectively, aggregating $56,143.12.

4. The determination of tax set forth in said notice of deficiency is based upon the following error:

The holding that petitioner was not affiliated with American Gas and Electric Company during the years in question.

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner's entire common stock, consisting of 12,500 shares, was owned by said American Gas and Electric Company throughout the years in question and had been so owned since the organization of the latter company in December, 1906. Such common stock constituted more than 77% of the total stock of petitioner, namely, 16,202 shares, the stock not so owned consisting of 3,702 shares of preferred stock. Certain stockholders of said American Gas and Electric Company owned from 17% to 21% of such preferred stock of petitioner.

(b) Under the terms of petitioner's charter its preferred stock could be redeemed at any time upon the vote of said American Gas and Electric Company, as owner of all the common stock.

(c) During the years in question approximately 50% of the preferred stockholders of petitioner always gave their proxies to the nominees of said American Gas and Electric Company.

(d) During the years in question no proxy was given by any preferred stockholder to anyone other than the nominees of American Gas and Electric Company, and no vote was ever cast contrary to the vote of American Gas and Electric Company.

(e) During the years in question the directors of petitioner, with one exception, were stockholders of American Gas and Electric Company and in most cases were either

directors or officers of American Gas and Electric Company.

[fol. 4] (f) Under a certain collateral trust agreement of American Gas and Electric Company that company (as holder of all the common stock of petitioner) might not permit petitioner to issue voting preferred stock to an amount exceeding 30% of the total outstanding stock of the petitioner.

(g) No class of capital stock of petitioner had cumulative voting rights, and accordingly the preferred stockholders could not elect a single director in opposition to American Gas and Electric Company, as owner of all the common stock.

(h) American Gas and Electric Company had guaranteed by endorsement the principal and interest of the bonded indebtedness of petitioner outstanding during the years in question and had also made unsecured loans to petitioner, the average balance owing to American Gas and Electric Company during the years in question being in excess of $200,000.

(i) On information and belief that a consolidation of the invested capital and income of petitioner with the invested capital and income of American Gas and Electric Company results in showing no deficiency in taxes for any of the years in question on the part of petitioner.

6. The petitioner prays for relief from the deficiency asserted by the respondent upon the following particulars:

That the invested capital, net income, and profits taxes for the years 1917, 1918, and 1919 and the income taxes for the years 1918 and 1919 be computed and determined on the basis of a consolidated return of petitioner and said American Gas and Electric Company.

That the entire deficiency be eliminated.

Wherefore petitioner prays that this board may hear and redetermine the deficiency herein alleged.

(Sgd.) Courtland Kelsey, Counsel for Petitioner.

Office & P. O. address: No. 120 Broadway, New York, N. Y.

Duly sworn to by Frank B. Ball. Jurat omitted in printing.

[fol. 5] EXHIBIT A TO PETITION

IT:CR:D-60D. TE

Treasury Department, Washington

April 26, 1926.

Atlantic City Electric Company, Atlantic City, New Jersey.

SIRS: An examination of your income and profits tax returns and of your books of account and records discloses a deficiency in tax for the years 1917, 1918, and 1919 of $56,143.12 as shown in the attached statement.

In accordance with the provisions of section 274 of the revenue act of 1926, you are allowed 60 days from the date of mailing of this letter within which to file a petition for the redetermination of this deficiency. Any such petition must be addressed to the United States Board of Tax Appeals, Earle Building, Washington, D. C., and must be mailed in time to reach the board within the 60-day period, not counting Sunday as the sixtieth day.

Where a taxpayer has been given an opportunity to file a petition with the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has filed a petition and an assessment in accordance with the final decision on such petition has been made the unpaid amount of the assessment must be paid upon notice and demand from the collector of internal revenue. No claim for abatement can be entertained.

If you acquiesce in this determination and do not desire to file a petition with the United States Board of Tax Appeals, you are requested to execute a waiver of your right to file a petition with the United States Board of Tax Appeals on the inclosed Form A, and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:CR:D-60D-TE. In the event that you acquesce in a part of the determination, the waiver should be executed with respect to the items to which you agree.

Respectfully, D. H. Blair, Commissioner, (Signed)
by C. R. Nash, Assistant to the Commissioner.

Enclosures: Statement, Waiver—Form A.

[fol. 6] Statement of Returns Examined and Resulting Tax Liability

Returns Examined

Name of Company	Years	Forms
Atlantic City Electric Company, Atlantic City, New Jersey	1917	1031-1103
	1918	1122
	1919	1122

Tax Liability

Company	Years	Additional tax
Atlantic City Electric Company	1917	$9,717.54
	1918	7,482.78
	1919	38,942.80
Total additional tax		56,143.12

Full details of the adjustment producing the above-stated results are contained in schedules attached to bureau letter dated January 8, 1926.

The previous action of the unit in holding that your company is not affiliated with the American Gas & Electric Co. during the years shown is reaffirmed.

In adjusting your tax liability due consideration was given to all information submitted at conference held on March 18, 1926, with representatives of your company and in briefs submitted, dated March 16, 1926.

Waivers properly executed for the years 1917, 1918, and 1919, expiring December 31, 1926, are on file in this office.

Before United States Board of Tax Appeals

[Title omitted]

Answer—Filed Aug. 25, 1926

Now comes the Commissioner of Internal Revenue, by his attorney, A. W. Gregg, General Counsel, Bureau of Internal Revenue, and for answer to the petition of the taxpayer, admits and denies as follows:

1. Admits the allegations of paragraph 1.

2. Admits the allegations of paragraph 2.

3. Admits the allegations of paragraph 3.

4. Denies the assignment of error contained in paragraph 4.

[fol. 7] 5. Denies the allegations of subdivisions (a), (b), (c), (d), (e), (f), (g), and (h) of paragraph 5.

Denies the allegations and conclusions contained in subdivision (i) of paragraph 5.

Wherefore it is prayed that the taxpayer's appeal be denied.

A. W. Gregg, General Counsel, Bureau of Internal Revenue. Of counsel: A. R. Marrs, Special Attorney, Bureau of Internal Revenue.

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

AMENDED PETITION—Filed Nov. 21, 1928

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, IT:CR: D-60D-TE, dated April 26, 1926, and as a basis of its proceedings alleges as follows:

1. The petitioner is a corporation of the State of New Jersey with principal office at No. 30 Church Street, New York, N. Y.

2. The notice of deficiency (a copy of which is attached and marked "Exhibit A") was mailed to the petitioner on April 26, 1926. The original petition was filed with the board on June 24, 1926.

3. The taxes in controversy are income and profits taxes for the calendar years 1917, 1918, and 1919 and for the amounts of $9,717.54, $7,482.78, and $38,942.80, respectively, aggregating $56,143.12.

4. The determination of the tax set forth in said notice of deficiency is based upon the following errors:

(a) The respondent erroneously determined that petitioner was not affiliated with American Gas and Electric Company during the years in question.

(b) The respondent erroneously deducted the full amount of petitioner's 1916 Federal income tax from its invested capital at the beginning of the year 1917, instead of giving effect to such reduction as of the time when such tax was payable.

(c) The respondent erroneously reduced petitioner's invested capital for the years 1918 and 1919 by incorrect amounts for Federal income and profits taxes in the preceding years, such taxes having been improperly computed.

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

[fol. 8] (a) Petitioner's entire common stock, consisting of 12,500 shares, was owned by said American Gas and Electric Company, throughout the years in question and had been so owned since the petitioner was formed by the consolidation of certain predecessor corporations in October, 1907. Such common stock constituted more than 77 per cent of the total stock of petitioner, namely, 16,202 shares, the stock not so owned consisting of 3,702 shares of preferred stock. Certain stockholders of said American Gas and Electric Company owned from 17% to 21% of such preferred stock of petitioner.

(b) Under the terms of petitioner's charter its preferred stock could be redeemed at any time upon the vote of said American Gas and Electric Company, as owner of all the common stock.

(c) The preferred stock of petitioner was limited as to the amount of dividends to which the holders were entitled; such dividends were not in arrears; and during each of the years in question such dividends were earned by a substantial margin and were regularly paid.

(d) During the years in question no proxy was given by any preferred stockholder to anyone other than the nominees of American Gas and Electric Company and no vote

was ever cast contrary to the vote of American Gas and Electric Company.

(e) Under a certain collateral trust agreement of American Gas and Electric Company, that company (as holder of all the common stock of petitioner) might not permit petitioner to issue voting preferred stock to an amount exceeding 30% of the total outstanding stock of the petitioner, or to issue additional common stock unless the same were acquired by American Gas and Electric Company.

(f) American Gas and Electric Company had guaranteed by endorsement the principal and interest of the bonded indebtedness of petitioner outstanding during the years in question, and had also made unsecured loans to petitioner, the average balance owing to American Gas and Electric Company during the years in question being in excess of $200,000.

(g) The petitioner is one of a large number of public utilities companies controlled and operated for the benefit of American Gas and Electric Company. Such control was evidenced in the following ways, among others:

1. All entries in petitioner's general books of account were made under the direction of its treasurer, who was also treasurer of American Gas and Electric Company, and whose office was in the New York office of the latter company. Petitioner's books were regularly audited by American Gas and Electric Company, and all financial statements and reports were regularly submitted to it.

2. All purchases of major importance were made for the petitioner by the purchasing department of the American Gas and Electric Company.

3. Petitioner's funds were deposited in local banks, but no withdrawals of such funds could be made for any purpose except by officers who held the same positions with American Gas and Electric Company as with petitioner, and whose offices were in the office of American Gas and Electric Company in New York.

4. Petitioner did all of its financing through the American Gas and Electric Company.

[fol. 9] 5. All engineering policies of the petitioner were dictated by the American Gas and Electric Company. All

construction work was done under the supervision of the American Gas and Electric Company.

6. All rates charged by the petitioner were first approved by the American Gas and Electric Company.

7. During the taxable years eight of the nine directors of petitioner were directors or officers of American Gas and Electric Company, and all meetings of petitioner's directors were held at the New York office of American Gas and Electric Company.

8. The president, vice president, secretary, and treasurer, and assistant secretary and assistant treasurer of the petitioner held like positions with the American Gas and Electric Company.

(h) Petitioner's total Federal income tax for the year 1916 was $3,001.50 and such tax was not required to be paid until June 15, 1917.

(i) On information and belief that a consolidation of the invested capital and income of petitioner with the invested capital and income of American Gas and Electric Company results in showing no deficiency in taxes for any of the years in question on the part of petitioner.

6. The petitioner prays for relief from the deficiency asserted by the respondent in the following particulars:

That the invested capital, net income, and profits taxes for the years 1917, 1918, and 1919 and the income taxes for the years 1918 and 1919 be computed and determined on the basis of a consolidated return of petitioner and said American Gas and Electric Company. That in any event petitioner's invested capital be recomputed so as to reflect only the proper reductions on account of Federal income and profits taxes for the preceding years.

That the entire deficiency be eliminated.

Wherefore, petitioner prays that this board may hear and redetermine the deficiency herein alleged.

Courtland Kelsey, Counsel for Petitioner.

Office and post-office address: No. 120 Broadway, New York, N. Y.

Duly sworn to by Frank B. Ball. Jurat omitted in printing.

[fol. 10] EXHIBIT "A" TO AMENDED PETITION

Treasury Department, Washington

IT: CR: D-60D. TE

April 26, 1926.

Atlantic City Electric Company, Atlantic City, New Jersey.

SIRS: An examination of your income and profits tax returns and of your books of account and records discloses a deficiency in tax for the years 1917, 1918, and 1919 of $56,143.12 as shown in the attached statement.

In accordance with the provisions of section 274 of the revenue act of 1926, you are allowed 60 days from the date of mailing of this letter within which to file a petition for the redetermination of this deficiency. Any such petition must be addressed to the United States Board of Tax Appeals, Earle Building, Washington, D. C., and must be mailed in time to reach the board within the 60-day period, not counting Sunday as the sixtieth day.

Where a taxpayer has been given an opportunity to file a petition with the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has filed a petition and an assessment in accordance with the final decision on such petition has been made, the unpaid amount of the assessment must be paid upon notice and demand from the collector of internal revenue. No claim for abatement can be entertained.

If you acquiesce in this determination and do not desire to file a petition with the United States Board of Tax Appeals, you are requested to execute a waiver of your right to file a petition with the United States Board of Tax Appeals on the enclosed Form A, and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT: CR: D-60D-TE. In the event that you acquiesce in a part of the determination, the waiver should be executed with respect to the items to which you agree.

Respectfully, D. H. Blair, Commissioner, (Signed) by C. R. Nash, Assistant to the Commissioner.

Enclosures: Statement, Waiver—Form A.

[fol. 11] Statement of Returns Examined and Resulting Tax Liability

Returns Examined

Name of company	Years	Forms
Atlantic City Electric Company, Atlantic City, New Jersey	1917	1031-1103
	1918	1122
	1919	1122

Tax Liability

Company	Years	Additional tax
Atlantic City Electric Company	1917	$9,717.54
	1918	7,482.78
	1919	38,942.80
Total additional tax	....	56,143.12

Full details of the adjustment producing the above-stated results are contained in schedules attached to bureau letter dated January 8, 1926.

The previous action of the unit in holding that your company is not affiliated with the American Gas & Electric Company during the years shown is reaffirmel.

In adjusting your tax liability due consideration was given to all information submitted at conference held on March 18, 1926, with representatives of your company and in briefs submitted, dated March 16, 1926.

Waivers properly executed for the years 1917, 1918, and 1919, expiring December 31, 1926, are on file in this office.

Before United States Board of Tax Appeals

[Title omitted]

Amended Answer

(Read Into Record of Hearing on November 21, 1928)

Mr. Meacham. * * * The respondent has not filed any amended answer, but I would like to have the record

show and, with your honor's permission, have the original answer deemed amended to deny the new matter which is set forth in the amended petition.

Mr. Kelsey: That is satisfactory.

Mr. Member: That will be done.

Mr. Meacham: That applies to both the Atlantic City Electric Company and the Scranton Electric Company.

The Member: Yes.

[fol. 12] BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket Nos. 17871 and 17872

Promulgated March 26, 1929

ATLANTIC CITY ELECTRIC COMPANY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

SCRANTON ELECTRIC COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

1. Affiliation.—Where the parent corporation owned all of the common stock of the petitioners, and preferred stock with voting rights, but redeemable at any time, was issued to others not in excess of 30 per cent, and the affairs of petitioners were absolutely dominated and controlled by the parent corporation, the corporations are affiliated and should file a consolidated return.

2. Idem.—Evidence examined and Scranton Electric Co. held affiliated with Lackawanna Light Co.

3. Invested capital.—Should be proportionately reduced by taxes for previous year and by amount of dividends paid during first sixty days of year.

Courtland Kelsey, Esq., for the petitioners.

Eugene Meacham, Esq., and C. E. Lowery, Esq., for respondent.

Petitioners seek redetermination of alleged deficiencies in income and profits taxes, as follows: Atlantic City Electric Company, year 1917, $9,717.54; year 1918, $7,482.78; year 1919, $38,942.80. Scranton Electric Company, year 1917, $13,736.03; year 1918, $236,207.41; year 1919, $129,151.99. Separate proceedings were filed in behalf of each petitioner, each including the three years in controversy, which were consolidated for hearing and determination.

In behalf of both petitioners it is alleged that the respondent erred, (1) in refusing to affiliate the petitioner with the American Gas and Electric Company; (2) in reducing petitioner's invested capital at the beginning of the year 1917 by the full amount of its 1916 Federal income tax, instead of giving effect to the reduction as of the date when such tax was due and payable; and (3) in reducing petitioner's invested capital for the years 1918 and 1919 by incorrect amounts of income and profits taxes in the preceding years, resulting from the improper calculation of such taxes for the preceding years. At the hearing counsel for the petitioners agreed with reference to error (3) that once the proper tax was determined for the years 1918 and 1919, no error would be assigned relative to the treatment of the same by the respondent for invested capital purposes.

It was further alleged in behalf of the Scranton Electric Company that respondent erred, (1) in failing to affiliate Scranton Electric Company with the Lackawanna Light Company, a subsidiary; (2) in reducing petitioner's invested capital for the year 1917 by the amount of $108,237.50 on account of dividends declared or paid during the first 60 days of the year, when only $66,050 was declared or paid during the first 60 days of 1917; and (3) in reducing invested capital for 1918 in the sum of $24,029.45, amount of so-called tentative tax. The last error assigned was waived at the hearing.

[fol. 13] FINDINGS OF FACT

Respondent determined deficiencies herein on the basis of separate returns of each petitioner and did not consolidate either of said returns with that of the American Gas and Electric Company, or that of the Scranton Electric Company with that of the Lackawanna Light Company.

The Atlantic City Electric Company is a corporation organized March 21, 1907, under the laws of New Jersey, by which several light, heating, and power companies operating in and around Atlantic City, New Jersey, were consolidated. During the taxable years it had outstanding 12,500 shares of common stock of the par value of $100 per share, all of which was owned by the American Gas and Electric Company, and 3,702 shares of preferred stock, of which from 655 to 761 shares were owned by the stockholders of the American Gas and Electric Company during the taxable years. The American Gas and Electric Company owned absolutely more than 77 per cent of the total outstanding stock of the Atlantic City Electric Company. Holders of preferred stock were entitled to vote, and the stock was preferred to the extent of an annual cumulative dividend of six per cent and on final liquidation. It was redeemable at any time and had no other interest in dividends above six per cent.

The Scranton Electric Company is a corporation organized October 3, 1907, under the laws of Pennsylvania, and resulting from the consolidation and merger of several lighting, heating, and power companies operating in and around Scranton.

From its organization and during the taxable year it had outstanding 25,000 shares of common stock of the par value of $100 each, all of which was owned by the American Gas and Electric Company. It had 10,700 shares of preferred stock of which 494 to 608 shares were owned by stockholders of the American Gas and Electric Company. The American Gas and Electric Company was the absolute owner of more than 70 per cent of the outstanding capital stock of the Scranton Electric Company during the taxable years. The preferred stock of this company was of the same character as that of the Atlantic City Electric Company, and in both petitioners preferred stock was redeemable at any time by vote of the common stock.

The Scranton Electric Company was the absolute owner of the entire capital stock of $400,000 of the Lackawanna Light Company during the taxable years, was affiliated with the latter, and was entitled to file a consolidated return including the latter.

During the taxable years and for many years prior thereto the American Gas and Electric Company was a

holding corporation and was the absolute owner of the entire common stock issues of from 30 to 40 lighting and power companies in the Atlantic and Middle States. Some of these companies had preferred stock and others not, some of the preferred stock had voting rights and others not, but in each instance the American Gas and Electric Company owned all of the common stock and more than 50 per cent of the voting stock of each subsidiary.

The entire common stock of both petitioners and other companies was pledged in 1907 by the American Gas and [fol. 14] Electric Company under a collateral trust agreement to secure certain collateral trust bonds of the pledgor and it was provided in said agreement that voting preferred stock might not be issued by either of the petitioners in an amount exceeding 30 per cent of the total outstanding stock of such petitioner.

The American Gas and Electric Company has in excess of 3,000 stockholders many of whom from time to time may have been owners of preferred stock in one or more of the subsidiary companies, but the control and ownership exercised by the American Gas and Electric Company resulted from its absolute ownership of the entire common stock of its subsidiaries and not from control or ownership of preferred stock by its stockholders.

In no instance during the years in question did the holder of preferred stock in either petitioner vote against or object to any action taken at any stockholders' or directors' meeting, nor against any proposition advanced by the American Gas and Electric Company or its representatives, but voted in conformity thereto. Dividends on the preferred stock in the contract amount of six per cent were always paid promptly and there has never been any unpaid cumulative dividends.

The president, vice president, secretary, and treasurer, and assistant secretary and assistant treasurer of the American Gas and Electric Company occupied the same positions with both petitioners. The major operations of all of them were carried on at the office of the American Gas and Electric Company in New York City. The directors of both petitioners were directors of the American Gas and Electric Company, with the exception of four in

the Scranton Electric Company, who were required by law to be residents of Pennsylvania, and all directors' meetings were held in the office of the American Gas and Electric Company in New York City.

All salaries paid by petitioners to its officers were immediately turned over by them to the American Gas and Electric Company, from which company they received their compensation for their services rendered all companies.

All financial matters and operations were conducted by and carried on through the American Gas and Electric Company. The accounting system of petitioners was installed under instructions from the American Gas and Electric Company and monthly reports were required to be made to the latter. The books were regularly audited by it and rates of depreciation, charging off of bad debts, and extensions and improvements were dictated by the American Gas and Electric Company.

Local collections were made by the local officers and employees of the petitioners, but when deposited could only be disbursed upon orders or checks authorized by officials of the American Gas and Electric Company, who were also officers of the petitioners. All construction work of either petitioner had first to be approved by the American Gas and Electric Company, and was done under the supervision of the engineering department of the latter. Except local or temporary supplies, all materials were purchased through the American Gas and Electric Company.

Large sums of money were advanced from time to time to each of the petitioners by the American Gas and Elec- [fol. 15] tric Company, varying in amount from $100,000 to $2,000,000 on open account for construction work and acquisition of other plants. In order to repay these loans petitioners issued their preferred stock or bonds, which were guaranteed by the American Gas and Electric Company, which in turn marketed the securities.

The respondent reduced the invested capital of the Scranton Electric Company for the year 1917 by the sum of $108,237.50 on account of dividends declared or paid within the first 60 days of the year. In the first 60 days of the year 1917 dividends were declared or paid in the sum of $66,050.

Respondent reduced the invested capital of the Atlantic City Electric Company as of January 1, 1917, by the full

amount of its 1916 taxes, to wit, $3,001.50, and took the same action as concerns the Scranton Electric Company in the amount of $10,343.95.

OPINION

MILLIKEN:

The principal question involved in these proceedings concerns the right of the affiliation of the petitioners with the American Gas and Electric Company. Corporations are deemed to be affiliated when one corporation owns or controls through closely affiliated interests substantially all of the stock of the other or others or when substantially all of the stock of two or more corporations is owned or controlled by the same interests.

In the instant case the parent corporation is the American Gas and Electric Company, which will hereinafter be referred to as company, which established headquarters in New York City and is engaged in the lighting and power business in approximately 35 cities. Its business is carried on through local corporations in each community, which it serves in order to comply with local laws or conditions, but in each instance, as in that of the petitioners, the parent company owned the entire common stock, and thus retained at all times absolute control of the business and substantially all of the stock of the subsidiary. In some cases, where improvements, additions, or extensions were made by a subsidiary, preferred stock was issued by the local subsidiary to pay for the same. In the case of petitioners this preferred stock was 6 per cent cumulative with voting rights but was redeemable at any time at the option of the company. In the case of the Atlantic City Electric Company, the preferred stock amounted to a little less than 23 per cent of the total outstanding stock, while in the Scranton Electric Company it represented less than 30 per cent. A great deal of the preferred stock was owned by stockholders of the parent company. All of the officers of both petitioners occupied similar positions with the parent company, as did also all directors except four in the Scranton Electric Company. The salaries of the officers were paid by petitioners, who immediately turned them over to the parent company, which paid the officers for their serv-

ices to all companies. All directors' meetings were held in the office of the parent company, from whence came directions to all subsidiaries, including the petitioners, as to the conduct of their business to the most minute detail. Receipts of all companies were collected and deposited with the local employees, which could only be disbursed by officers of the local company, who were also officers of the [fol. 16] parent company. No improvements or capital expenditures could be made, except after approval by the parent company, and all such work was planned and performed under the supervision of its engineering department. Materials in quantity were likewise purchased through and by the parent company. Matters of policy such as the determination of depreciation rates, charging off bad debts, and expansion programs were under the direct supervision of the parent company.

The accounting systems of petitioners were installed by and operated in accordance with the direction of the parent company as well as all financial transactions. When advances of sums of money were needed by the petitioners the parent company made such advances without security from the former and in order to repay such advances, preferred stock or bonds of the petitioners were from time to time issued, which bonds and stock were guaranteed by the parent company and usually sold by them.

By reason of the provisions of the collateral trust agreement the petitioners were prohibited from issuing voting preferred stock which would represent more than 30 per cent of the total outstanding capital stock of either of the petitioners. The charter of each of the petitioners provided that the preferred stock might be redeemed by the common at any time. The company, therefore, had it within its power, if necessity therefor arose, to call in and redeem the preferred stock of the petitioners. The power to exercise such a right by the company goes further than a mere option which a parent company may have providing that they are to be given the first call as to the purchase of the stock of a stockholder if the latter desires to sell. The preferred stockholders of petitioners had no election whatsoever but to turn in their stock and have it redeemed if the parent company desired the same. The holder of the preferred stock resembled a creditor of the corporation more than he resembled a common-stock holder. Like a

creditor he was entitled to a return on his money invested, to have his money repaid before a common-stock holder, but likewise he does not share in the earnings or assets except to a specified extent. He could in this case be paid off at any time and his connection with the petitioners terminated. There was also no provision whereby his stock could be exchanged for common stock. In the entire history of these petitioners it does not appear that any holder of preferred stock ever objected to any corporate action. The dividends on the preferred stock at all times have been promptly paid.

The dominant purpose sought to be attained by the Congress in providing for consolidated returns was to prevent or neutralize inter-company transactions that would result in tax evasions. It sought to tax as a whole what in truth was the income of but a single enterprise. When we seek to give effect to that purpose, resort should be had to all the facts obtaining and not merely set up a dead line, beyond which we will not go, that is marked only by mere percentages of stock ownership. Looking to and giving proper significance as concerns stock ownership, limitations surrounding the ownership of preferred stock, and the complete business dominance of petitioners by the parent company, we believe the test has been met and the petitioners and the parent company should be required to file consolidated returns for the years in question.

[fol. 17] A decision in support of the views herein taken is the recent case of the Great Lakes Hotel Co. v. Commissioner, decided by the United Circuit Court of Appeals for the Seventh Circuit, December 20, 1928.

In that case one corporation with closely affiliated interests owned 71 per cent of the stock of three other corporations, 78 per cent of the stock of a fourth, and 90 per cent of the stock of two others. There was an understanding that if minority stockholders wished to sell their stock they would first offer it to the majority stockholders. All but two of the corporations carried on separate and distinct kinds of business, but each was a part of the general scheme or system relating to the construction, financing, and operation of hotels. The court held the corporations were affiliated and said in part:

"Without going into an extensive discussion, we will merely state our conclusions, which are—

"(a) The word 'controlled' is more comprehensive than the word 'owned' as used in this section.

"(b) The 'same interests' and 'closely affiliated interests' describe the same group, the latter expression enlarging what might otherwise be embraced in the term 'same interests.' Both expressions were intended to include more than 'same owner.' An examination of the facts in each case is necessary to ascertain who, among the stockholders, comprise the group thus designated.

"(c) 'Substantially all the stock' is a lax, indefinite expression which, under the rulings of the board, is equivalent to 'a large majority.' Its limitations can not be defined with exactness or certainty. When the commissioner promulgated article 633 of its regulations 45 and announced that ownership of more than 51% of the capital stock of the corporation might, under certain circumstances, be 'substantially all of the stock' he was exercising legislative rather than administrative powers and acting beyond his authority.

"Applying these conclusions to the facts in the case before us, we have no hesitancy in holding that the majority stockholders in each of the six corporations comprise a group which comes within the statutory designation of 'closely affiliated interests.' They were guided in their action by a common interest and their common object was attained by all corporations pursuing the same methods through the same agencies. In addition to owning more than one-half of the stock these 'closely affiliated interests' controlled other stock. For example, there was an understanding that if any minority stockholder wished to sell his stock, it should first be offered for sale to H. L. Stevens & Co., and as a matter of practice such minority stockholders offered their stock to H. L. Stevens & Co., and this company actually purchased the stock thus offered. In addition, the various minority stockholders executed proxies to the 'closely affiliated interests' by the terms of which the latter were authorized to vote for, and act for, the former. A large group of minority stockholders made sworn statements that 'at the time they purchased their stock * * * they had full confidence in the rectitude and business ability of H. L. Stevens and

that they anticipated that he would continue as president of the Stevens Co. and that if they desired to sell their stock it was their understanding they should first offer it for sale to H. L. Stevens & Co.'

[fol. 18] "Upon this record we are satisfied that such stock was controlled by the so-called closely affiliated interests and that such stock added to the stock owned by the group that comprised the closely affiliated interests, constituted substantially all of the stock of these corporations.

"It follows from what has been said that petitioners and H. L. Stevens & Co., the Metropolitan Mortgage Co., Olmsted Hotel Co., the Lake Erie Hotel Co., and Valley Farm were affiliated domestic corporations within the meaning of section 240(b) and were required to make a consolidated return of their net income and to have their taxes computed and determined upon the basis of such consolidated return."

See also Lavenstein Corporation v. Commissioner, 25 Fed. (2d) 375.

In the case of Wilshire Oil Co., 13 B. T. A. 1150, three brothers owned all the stock of one corporation and 72 per cent of the stock of another. About half the remaining stock was owned by those described as "friends and associates" and the remaining half by "the public." In the course of the decision in that case the board said:

"When credit, material, supplies, services, or any assistance was needed by Bandini Company, it was supplied by petitioner or its stockholders. The stock in the hands of the public as distinguished from that represented by the preorganization subscription agreement was at all times agreeable to the management and conduct of the business of Bandini Company by the Machris Brothers.

"The case is strikingly like that of Midland Refining Company, Dec. 625, 2 B. T. A. 292, 296. There, as here, one company was an oil refining company and the other was a producing or drilling company organized for the purpose of providing crude oil for the former. The refining company took all the crude oil produced by the drilling company and there were intercompany transactions similar to those in the instant case, such as loaning of money, facilities, and equipment, interchange of officers and employees, occupation of same offices, and absolute domination of the

business of both companies by three persons, who endeavored to make both companies successful.

"In that case the dominant stockholders originally owned 90 per cent of the stock in the refining company and 78.26 per cent in the producing company, but part of their holdings was sold to friends, business associates, and employees, so that their holdings were reduced to 62.71 per cent and 51.07 per cent, respectively, yet on account of the close business relationship, we held that substantially all of the capital stock of both corporations was owned or controlled by the same interests."

See also Bank of Italy, 13 B. T. A. 1226.

We are not unmindful of the recent cases of Ice Service Company et al. v. Commissioner, and Commissioner v. Adolph Hirsh & Company, Inc., recently decided by the United States Circuit Court of Appeals for the Second Circuit, but not yet reported. In each of these cases there was a large minority interest, which was not controlled by the majority, and it was upon this lack of control that the cases were decided, while in the instant case we think the redemption feature attaching to the preferred stock left it in the control of the owners of the common stock.

[fol. 19] Relative to the claim of the Scranton Electric Company to affiliation with the Lackawanna Light Company, we accept the testimony of record that the Scranton Electric Company was the owner of the entire capital stock of $400,000 of the Lackawanna Light Company. The Scranton Electric Company is entitled to affiliation with the Lackawanna Light Company and should file a consolidated return with it.

The remaining questions relate to the invested capital of the respective petitioners for the year 1917. We think the respondent erred in reducing invested capital by deducting the full amount of their 1916 taxes as of January 1, 1917. Invested capital should be reduced when such tax becomes due and payable.

All American Cables, Inc., 10 B. T. A. 213.

The respondent erred in reducing the invested capital of the Scranton Electric Company for 1917 by $108,237.50, representing dividends declared or paid during the first sixty days of that year, as the uncontradicted evidence is

to the effect that only $66,050 in dividends was declared or paid during the first sixty days of the year.

Judgment will be entered under rule 50.

BEFORE UNITED STATES BOARD OF TAX APPEALS, WASHINGTON

Docket No. 17871

ATLANTIC CITY ELECTRIC COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION

Pursuant to opinion and findings of fact promulgated March 26, 1929, the respondent herein, to wit, on April 4, 1930, having filed amended notice of settlement for the years 1917, 1918, and 1919, and the petitioner on April 25, 1930, having filed notice of acquiescence to said amended notice of settlement, it is

Ordered and decided that there are deficiencies for the years 1917, 1918, and 1919 in the amounts of $170.34, $7,669.84, and $33,937.80 respectively.

(Signed) Logan Morris, Member.

Entered Apr. 30, 1930.

A true copy. Teste:

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

[fol. 20] BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

PETITION FOR REVIEW TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT—Filed Oct. 25, 1930

To the Honorable Judges of the United States Circuit Court of Appeals for the Second Circuit:

Now comes David Burnet, Commissioner of Internal Revenue, by his attorneys, G. A. Youngquist, Assistant Attor-

ney General, and C. M. Charest, general counsel, Bureau of Internal Revenue, and respectfully shows:

I

The petitioner on review (hereinafter referred to as the commissioner) is the duly appointed, qualified, and acting Commissioner of Internal Revenue of the United States, holding his office by virtue of the laws of the United States. The respondent on review (hereinafter referred to as the taxpayer) is a corporation organized and existing under and by virtue of the laws of the State of New Jersey, with its principal place of business at New York, State of New York. The income and profits tax returns of the taxpayer for the years 1917, 1918, and 1919, being the taxpayer years involved herein, were filed with the collector of internal revenue for the second district of New York, and the office of said collector is located within the judicial circuit of the United States Circuit Court of Appeals for the Second Circuit.

II

The commissioner determined deficiencies in income and profits taxes against the taxpayer for the years 1917, 1918, and 1919 in the amounts of $9,917.54, $7,482.78, and $38,942.80, respectively, and on April 26, 1926, in accordance with the provisions of section 274 of the revenue act of 1926, sent to the taxpayer by registered mail notice of said deficiencies. Thereafter the taxpayer filed an appeal from the said notice of deficiencies with the United States Board of Tax Appeals. The hearing of the said appeal by the Board of Tax Appeals was held on November 21, 1928. On March 26, 1929, the board promulgated its findings of fact and opinion in said appeal and on April 30, 1930, the board entered its final order of redetermination in said appeal, wherein and whereby the board ordered and decided that there were deficiencies for the years 1917, 1918, and 1919 in the amounts of $170.36, $7,689.84, and $33,937.80, respectively.

[fol. 21] III

Parts of the deficiencies which were in controversy before the Board of Tax Appeals arose or resulted from the determination of the commissioner that the taxpayer was not

affiliated with the American Gas and Electric Company during the years 1917, 1918, and 1919, within the meaning of section 1331 of the revenue act of 1921 and section 240 of the revenue act of 1918. The Board of Tax Appeals held that the taxpayer and the American Gas and Electric Company were affiliated during the years 1917, 1918, and 1919 within the meaning of section 1331 of the revenue act of 1921 and section 240 of the revenue act of 1918 and entered its final order of redetermining the taxes against the taxpayer for the years 1917, 1918, and 1919 in accordance with such holding.

IV

The commissioner says that in the record and proceedings before the Board of Tax Appeals and in the decision and final order of redetermination rendered and entered by the Board of Tax Appeals manifest error occurred and intervened to the prejudice of the commissioner, and the commissioner assigns the following errors, and each of them, which, he avers, occurred in the said record, proceedings, decision, and final order of redetermination and upon which he relies to reverse the said decision and final order of redetermination so rendered and entered by the Board of Tax Appeals, to wit:

1. The Board of Tax Appeals erred as a matter of law in holding that the taxpayer and the American Gas and Electric Company were affiliated and entitled to file consolidated returns for the years 1917, 1918, and 1919 within the meaning of section 1331 of the revenue act of 1921 and section 240 of the revenue act of 1918.

2. The Board of Tax Appeals erred in finding as a fact that the taxpayer and the American Gas and Electric Company were affiliated during the years 1917, 1918, and 1919 within the meaning of section 1331 of the revenue act of 1921 and section 240 of the revenue act of 1918.

3. The Board of Tax Appeals erred in failing to find as a fact that during the years 1917, 1918, and 1919 substantially all the stock of the taxpayer was not owned or controlled by American Gas and Electric Company.

4. The Board of Tax Appeals erred in failing to hold as a matter of law that during the years 1917, 1918, and 1919

substantially all the stock of the taxpayer was not owned or controlled by the American Gas and Electric Company.

5. The Board of Tax Appeals erred in that its finding that substantially all of the stock of the taxpayer was owned or controlled by American Gas and Electric Company during the years 1917, 1918, and 1919 is not supported by the evidence.

6. The Board of Tax Appeals erred in that its findings of fact do not support its decision and judgment.

7. The Board of Tax Appeals erred in determining that there were deficiencies against the taxpayer for the years 1917, 1918, and 1919 in the amounts of $170.34, $7,669.84, and $33,937.80, respectively.

[fol. 22] 8. The Board of Tax Appeals erred in not finding the deficiencies for the years 1917, 1918, and 1919 to be the amounts stated in the notice of deficiencies.

Wherefore the commissioner petitions that the decision of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Second Circuit and that a transcript of the record be prepared in accordance with law and with the rules of said court and transmitted to the clerk of said court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said court.

(Sgd.) G. A. Youngquist, Assistant Attorney General. (Sgd.) C. M. Charest, General Counsel, Bureau of Internal Revenue.

Duly sworn to by C. M. Charest. Jurat omitted in printing.

Before United States Board of Tax Appeals

[Title omitted]

Notice of Petition for Review—Filed Oct. 31, 1930

To Courtland Kelsey, Esq., 120 Broadway, New York, New York, Attorney for respondent on review:

Notice is hereby given to you that the Commissioner of Internal Revenue, petitioner on review in the above-entitled

proceeding, did on the 25th day of October, 1930, file with the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit [fol. 23] Court of Appeals for the Second Circuit of the decision rendered by the said Board of Tax Appeals in said proceeding, a copy of which said petition for review as filed herewith is served upon you.

(Sgd.) C. M. Charest, General Counsel, Bureau of Internal Revenue.

Service of the foregoing notice and a copy of the petition for review mentioned in said notice is acknowledged this 27th day of October, 1930.

(Sgd.) Courtland Kelsey, Attorney for Respondent on Review.

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

NOTICE OF PETITION FOR REVIEW—Filed Oct. 31, 1930

To Atlantic City Electric Company, 30 Church Street, New York, New York, Respondent on Review:

Notice is hereby given to you that the Commissioner of Internal Revenue, petitioner on review in the above-entitled proceeding, did on the 25th day of October, 1930, file with the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Second Circuit of the decision rendered by the said Board of Tax Appeals in said proceeding, a copy of which said petition for review as filed is herewith served upon you.

(Sgd.) C. M. Charest, General Counsel, Bureau of Internal Revenue.

Service of the foregoing notice and a copy of the petition for review mentioned in said notice is acknowledged this 27th day of October, 1930.

Atlantic City Electric Company, (Sgd.) by J. F. McMillan, Respondent on Review, Asst. Treas.

[fol. 24] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

Docket No. 17871

DAVID BURNET, Commissioner of Internal Revenue, Petitioner,

v.

ATLANTIC CITY ELECTRIC COMPANY, Respondent

PRÆCIPE FOR RECORD—Filed Oct. 3, 1931

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit, and deliver to the clerk of the United States Circuit Court of Appeals for the Second Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause in connection with the petition for review by the said Circuit Court of Appeals for the Second Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries of the proceedings before the board.
2. Pleadings before the board:
(a) Petition, including annexed copy of deficiency letter.
(b) Answer.
(c) Amended petition.
(d) Answer to amended petition as set forth on page 15 of transcript of hearing held on November 21, 1928.
3. Findings of fact, opinion, and decision of the board.
4. Petition for review, together with proof of service of notice of filing petition for review and of service of a copy of petition for review.
5. Orders enlarging time for the preparation of the evidence and for the transmission and delivery of the record not included in record.
6. This præcipe.

(Signed) C. M. Charest, General Counsel, Bureau of Internal Revenue.

Service of a copy of the within præcipe is hereby admitted this 30th day of September, 1931.

Courtland Kelsey, Attorney for Respondent.

[fol. 25] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

B. T. A.—No. 17871

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

ATLANTIC CITY ELECTRIC COMPANY, Respondent

B. T. A.—No. 17872

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

SCRANTON ELECTRIC COMPANY, Respondent

STIPULATION THAT DECISION SHALL APPLY TO DOCKET NO. 17872—Filed Nov. 27, 1931

It is hereby stipulated and agreed, by and between counsel for the parties to the above-entitled causes, that inasmuch as the issues involved in both cases are precisely the same, and the proceedings were consolidated for hearing and decision before the United States Board of Tax Appeals, and since the transcripts of record on petition for review are the same, except as to the amounts involved, no useful purpose would be served by hearing the cases separately before this honorable court.

In view of the foregoing, it is hereby stipulated and agreed that the printing of the transcript of record in the case of Commissioner of Internal Revenue v. Scranton Electric Company, B. T. A.—No. 17872, may be dispensed with; that the transcript of record need be printed and brief filed by the parties in the case of Commissioner of Internal Revenue v. Atlantic City Electric Company, B. T. A.—No. 17871, only; and that the decision of the court in the latter case will control and be accepted by the parties as the decision in the case of Commissioner of Internal Revenue v. Scranton Electric Company.

(Signed) C. M. Charest, Counsel for Petitioner.
(Signed) Courtland Kelsey, Counsel for Respondent.

So ordered.

Manton, U. S. C. J.

Nov. 22, 1931.

[fol. 26] Clerk's certificate to foregoing transcript omitted in printing.

[fol. 27] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

B. T. A.—No. 17871

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

vs.

ATLANTIC CITY ELECTRIC COMPANY, Respondent

B. T. A.—No. 17872

COMMISSIONER OF INTERNAL REVENUE

vs.

SCRANTON ELECTRIC COMPANY, Respondent

STIPULATION THAT DECISION SHALL APPLY TO DOCKET NO. 17872—Filed Nov. 23, 1931

It is hereby stipulated and agreed, by and between counsel for the parties to the above-entitled causes, that inasmuch as the issues involved in both cases are precisely the same and the proceedings were consolidated for hearing and decision before the United States Board of Tax Appeals, and since the transcripts of record on petition for review are the same, except as to the amounts involved, no useful purpose would be served by hearing the cases separately before this Honorable Court.

In view of the foregoing, it is hereby stipulated and agreed that the printing of the transcript in the case of Commissioner of Internal Revenue v. Scranton Electric Company, B. T. A. No. 17872, may be dispensed with; that the transcript of record need be printed and brief filed by the parties in the case of Commissioner of Internal Revenue v. Atlantic City Electric Company, B. T. A. No. 17871 only, and that the decision of the Court in the latter case will control and be accepted by the parties as the decision

in the case of Commissioner of Internal Revenue v. Scranton Electric Company.

C. M. Charest, Counsel for Petitioner. Courtland Kelsey, Counsel for Respondent.

So ordered.

Manton, U. S. C. J.

Nov. 23, 1931.

[fol. 28] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

[Title omitted]

STIPULATION AND ADDITION TO RECORD

Whereas the respective net taxable incomes of the Atlantic City Electric Company and the Scranton Electric Company for the years 1917, 1918, and 1919 did not appear in the records filed in the above cases, now therefore it is understood and agreed between the parties hereto that the net taxable incomes of the said companies for the said years was as follows:

Taxable year	Atlantic City Electric Company	Scranton Electric Company
1917	$173,385.09	$554,605.73
1918	64,356.49	614,465.16
1919	219,949.13	662,982.77

It is also understood and agreed that the net loss of the Lackawanna Light Company, also involved in these appeals, for the year 1917 was $31,197.41.

It is agreed that the above figures showing the respective net taxable incomes of the above companies for the years involved, including the net loss of the Lackawanna Light Company for the year 1917, shall be treated and considered as a part of the records filed in the above entitled cases.

G. A. Youngquist, Assistant Attorney General. Courtland Kelsey, Counsel for the Respondent.

Mar. 3, 1932.

[fol. 29] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, OCTOBER TERM, 1931

No. 330

Argued March 11, 1932. Decided April 4, 1932

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

ATLANTIC CITY ELECTRIC COMPANY, Respondent

Appeal from the United States Board of Tax Appeals

Before Manton, Augustus N. Hand, and Chase, Circuit Judges

Petition to review a decision of the Board of Tax Appeals (15 B. T. A. 1084) redetermining deficiencies for the years 1917, 1918, and 1919. The Commissioner seeks this review pursuant to the provisions of sections 1001-1003 of the Revenue Act of 1926, c. 27 (44 Stat. 9, 109, 110 [26 U. S. C. A. §§ 1224-1226]). Order reversed.

G. A. Youngquist, Asst. Atty. Gen., Sewall Key and J. P. Jackson, Sp. Assts. to Atty. Gen. (C. M. Charest, Gen. Counsel, Bureau of Internal Revenue, Eugene Meacham, Sp. Atty. Bureau of Internal Revenue, both of Washington, D. C., of counsel), for petitioner.

Graham Sumner and Courtland Kelsey, both of New York City, for respondent.

OPINION

MANTON, Circuit Judge:

The respondent, a taxpayer, and the Scranton Electric Company, are public service corporations. The former is organized under the laws of New Jersey and the latter under the laws of Pennsylvania. The Board considered their petitions together, and it is now stipulated that the petition of the respondent be considered and determined and that the decision of this court be accepted as controlling in the Scranton Electric Company appeal, for the questions involved are similar.

The petitioner determined deficiencies on the basis of separate returns for each taxpayer and refused to allow them to file consolidated returns with the American Gas & Electric Company, which company owned all the common stock of this respondent. The respondent supplied light, heat, and power service to Atlantic City, N. J., and its environs. It was organized in 1907, and during the taxable years it had outstanding 12,500 shares of common stock of the par value of $100, and 3,702 shares of preferred stock, 655 to 761 shares of which were owned by stockholders of the American Gas & Electric Company. This company therefore was a stockholder of 77 per cent of the total outstanding stock of respondent. The preferred stock was entitled to vote, and was preferred to the extent of an annual cumulative dividend of 6 per cent, and also on final distribution. It was redeemable at any time.

The Scranton Electric Company was organized in October, 1907, and resulted from a merger of several heating, lighting, and power companies. All its outstanding common stock was held by the American Gas & Electric Company as well as 494 to 608 shares of its 10,700 shares of preferred stock, which gave the American Gas & Electric Company ownership of 70 per cent of the outstanding capital stock. The preferred stock had the same privileges as to voting redemption and dividends as that of the respondent. The American Gas & Electric Company was a holding corporation, and had absolute ownership of some 30 or 40 lighting and power companies in the Atlantic and Middle States. Some had preferred stock outstanding; others had not. The entire common stock of both the respondent and the Scranton Company was pledged under a collateral trust agreement to secure collateral trust bonds of the American Gas & Electric Company, and it was provided that preferred stock should not be issued by either of these taxpayers in an amount exceeding 30 per cent of [fol. 30] the total outstanding stock. The American Gas & Electric Company had more than 3,000 stockholders, some of whom were the owners of preferred stock in one or more of its subsidiary companies, but the control and ownership was exercised by the American Gas & Electric Company through its ownership of the common stock. Dividends were regularly paid. The officers of the American Gas &

Electric Company held similar positions with both taxpayers. The directors of both taxpayers were directors in the American Gas & Electric Company, except four of the Scranton Company who were required by law to be residents of the state of Pennsylvania. The principal office of the American Gas & Electric Company was in New York City, where its general accounting system was kept and the business operations of both taxpayers were conducted. Local collections were made by the local officers and employees of the taxpayers, but when disbursements on deposits were to be made, they were authorized by the American Gas & Electric Company. Construction work was done and improvements were made only after approval by the American Gas & Electric Company.

The Board decided that the Scranton Company was entitled to affiliation with the Lackawanna Light Company for the years in question, and that they might file a consolidated return. It held that the Scranton Company and the respondent were affiliated with the American Gas & Electric Company, and that these companies might file consolidated returns.

The petitioner argues that, before these corporations are entitled to affiliation, it must appear that one corporation owns directly or controls through closely affiliated interests or by a nominee substantially all the stock of the other or others, or that substantially all the stock of two or more of the corporations is owned or controlled by the same interests. Section 1331 of the Revenue Act of 1921, c. 136, 42 Stat. 227, 319; section 240 of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1081. Both statutes are concerned with the control of stock and make no distinction between preferred and common stock. They do relate to voting stock. Handy & Harman v. Burnet, Com'r, 284 U. S. 136, 52 S. Ct. 51, 76 L. Ed. —; Com'r of Internal Revenue v. Shillito Realty Co. (C. C. A. 6) 39 F. (2d) 830, 69 A. L. R. 1266, Ice Service Co. v. Com'r of Internal Revenue, 30 F. (2d) 230 (C. C. A. 2); Com'r of Internal Revenue v. Adolph Hirsch & Co., 30 F. (2d) 645 (C. C. A. 2).

The question is therefore presented whether the American Gas & Electric Company owned directly or controlled all, or substantially all, the voting stock of each of the taxpayers, or whether similar interests owned and controlled

substantially all the voting stock of the three corporations. With 77 and 70 per cent., respectively, of the voting stock owned by the American Gas & Electric Company, there was still outstanding redeemable preferred stock in the hands of third parties. Ownership of 76 per cent was held not to constitute substantially all the stock of a corporation in Handy & Harman v. Burnet, Com'r, supra; 85 per cent in Burnet v. Bank of Italy, 46 F. (2d) 629 (C. C. A. 9); 77 to 84 per cent in United States v. Cleveland, P. & E. R. Co., 42 F. (2d) 413 (C. C. A. 6); 83½ per cent in Jos. Denunzio Co. v. Com'r of Internal Revenue, 49 F. (2d) 41 (C. C. A. 6); and 80 per cent in Wadhams & Co. v. United States, 67 Ct. Cl. 235.

The respondent argues that, since the preferred stock of both taxpayers was subject to redemption at any time by vote of the common, the American Gas & Electric Company therefore controlled the preferred stock held by the other stockholders. It was found by the Board that the preferred stockholders regularly voted in accordance with the wishes of the American Gas & Electric Company and permitted that company to control and carry on the business of the taxpayer companies. But control as used in the statute refers to stock control, not control of the business. It must be a legal enforceable control as distinguished from a control resting solely on acquiescence, exigencies of business, or other considerations which have no binding force. Handy & Harman v. Burnet, Com'r, supra. The right to redeem stock by purchase means nothing in the matter of control until exercised. It gave the common stockholders here no control over the preferred which was enforceable at law. There was no right to vote or to otherwise control it for the purposes of management of the corporation. Peytona Lumber Co. v. Com'r (C. C. A. 4) 55 F. (2d) 27, decided Jan. 14, 1932. Until the option to purchase was exercised, the holders of the preferred stock were not only the beneficial owners, but also the legal owners, with the right to use the stock in any manner they wished, whether for control of the corporation or for pur-

[fol. 31] poses of management. See Burnet v. Howes Bros. Hide Co., 284 U. S. —, 52 S. Ct. 126, 76 L. Ed. — decided November 23, 1931. It is not enough to have merely the business and financial control of the corporations which

are claimed to be affiliated. It requires more, to wit, stock control. Ice Service Co. v. Com'r of Internal Revenue, supra; Com'r of Internal Revenue v. Adolph Hirsch & Co., supra.

The Board of Tax Appeals erroneously held that affiliation existed, and therefore a consolidated return might be filed under the statute.

Order reversed.

[fol. 32] In United States Circuit Court of Appeals, Second Circuit

At a stated term of the United States Circuit Court of Appeals in and for the Second Circuit, held at the court rooms, in the Post Office building, in the city of New York, on the 11th day of April, one thousand nine hundred and thirty-two.

Present: Hon. Martin T. Manton, Hon. Augustus N. Hand, Hon. Harrie B. Chase, Circuit Judges.

Commissioner of Internal Revenue, Petitioner,

vs.

Atlantic City Electric Company, Respondent

Appeal from the United States Board of Tax Appeals

Judgment—Filed April 12, 1932

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged, and decreed that the order of said United States Board of Tax Appeals be, and it hereby is, reversed.

It is further ordered that a Mandate issue to the said Board in accordance with this decree.

Wm. Parkin, Clerk.

[fol. 33] [File endorsement omitted.]

[fol. 34] Clerk's certificate to foregoing transcript omitted in printing.

[fol. 35] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 10, 1932

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Endorsed on cover: File No. 36,860. U. S. Circuit Court of Appeals, Second Circuit. Term No. 163. Atlantic City Electric Company, petitioner, vs. Commissioner of Internal Revenue. Petition for a writ of certiorari and exhibit thereto. Filed June 17, 1932. File No. 36,860.

FILED SEP

No. 163

JUN 17 19
CHARLES ELMORE

IN THE

Supreme Court of the United States.

OCTOBER TERM—1932.

ATLANTIC CITY ELECTRIC COMPANY,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

GRAHAM SUMNER,
Counsel for Petitioner.

COURTLAND KELSEY,
CHARLES F. McISAAC,
Of Counsel.

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Supreme Court of the United States

OCTOBER TERM—1932.

No.

ATLANTIC CITY ELECTRIC COMPANY,
Petitioner,

AGAINST

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

TO THE HONORABLE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your Petitioner, Atlantic City Electric Company, respectfully prays for a writ of certiorari to review the decision of the United States Circuit Court of Appeals for the Second Circuit entered April 11, 1932 (R. p. 33), reversing a decision of the United States Board of Tax Appeals entered April 30, 1930 (R. p. 19).

This case came before the Board of Tax Appeals with another similar case which involved the Scranton Electric Company, but it was stipulated that the record in the case of the Scranton Electric Company need not be printed and

that the decision of the Circuit Court of Appeals in the case of the Atlantic City Electric Company would control and be accepted as the decision in the case of the Scranton Electric Company (R. p. 25).

This case came before the Circuit Court of Appeals on a petition to review the decision of the Board of Tax Appeals filed by the Commissioner of Internal Revenue October 25, 1930, pursuant to the provisions of Sections 1001, 1002 and 1003 of the Revenue Act of 1926, 44 Stat. 109, 110 (R. pp. 20-3).

Statement of Matter Involved.

Several questions were involved before the Board of Tax Appeals but the only question raised by the Commissioner on the appeal to the Circuit Court of Appeals, and the only question decided by that Court, is whether the Federal taxes for 1917, 1918 and 1919 should be determined upon the basis of individual returns or the basis of a consolidated return.

This question depends upon whether the taxpayers were affiliated with the American Gas and Electric Company within the meaning of Section 1331 of the Revenue Act of 1921 (42 Stat. 227) amending the Revenue Act of 1917 and Section 240 of the Revenue Act of 1918 (40 Stat. 1057). The Commissioner determined that the taxpayers were not affiliated with the American Gas and Electric Company, the Board of Tax Appeals held that they were so affiliated and the Circuit Court of Appeals held that they were not so affiliated.

The facts appear in the decision of the Board of Tax Appeals (R. pp. 13-15) and the stipulation of counsel showing the amount of the net incomes of the taxpayers for the taxable years (R. p. 28).

The Atlantic City Electric Company, one of the taxpayers, is a New Jersey corporation which was formed by the consolidation of several lighting, heating and power companies operating in and around Atlantic City, N. J. It had outstanding during the taxable years 12,500 shares of

common stock and 3,702 shares of preferred stock. The Scranton Electric Company, the other of the taxpayers, is a Pennsylvania corporation which was formed by the consolidation and merger of several lighting, heating and power companies operating in and around Scranton, Pa. It had outstanding during the taxable years 25,000 shares of common stock and 10,700 shares of preferred stock (R. p. 13).

The preferred stock of the two taxpayers was of the same character. In both cases the preferred stock was entitled to vote, was preferred over the common stock to the extent of an annual cumulative dividend of 6% and on final liquidation, and was redeemable at any time by vote of the common stock. The preferred stock had no interest in dividends above 6% per annum (R. p. 13).

Dividends on the preferred stock of the taxpayers have always been paid promptly and there have never been any unpaid accumulated dividends (R. p. 14). The net earnings exceeded the preferred dividend requirements many times over. In the case of the Atlantic City Company, the preferred dividends amounted to $22,200 per annum, while the net income for the taxable years averaged more than $152,000. In the case of the Scranton Company, the preferred dividends amounted to $64,200 per annum, while the net income averaged more than $610,000 for the taxable years (Stipulation of counsel, R. p. 28).

The American Gas and Electric Company is a holding corporation which during the taxable years was the absolute owner of all the common stock of thirty to forty lighting and power companies in the Atlantic and Middle states, including all the common stock of the taxpayers. Some of these companies had preferred stock and others not. Some of the preferred stock had voting rights and others not, but in each case American Gas and Electric Company owned all the common stock and more than 50% of the voting stock (R. p. 13).

The business of the American Gas and Electric Company was to control, manage, finance and develop lighting, heating

and power companies, and its control over the taxpayers and the conduct of their business was as complete as if it had owner every share of their outstanding stocks. The preferred stockholders of the taxpayers never voted against or objected to any action taken at any stockholders' or directors' meeting or any proposition advanced by the American Gas and Electric Company. Their dividends were adequately secured, they had no occasion to concern themselves with any of the details of management and they apparently were entirely satisfied with the management (R. pp. 14-5).

Section 1331 of the Revenue Act of 1921 provided in substance that the taxes imposed by the Revenue Act of 1917 should be determined upon the basis of consolidated returns in the case of domestic corporations which were affiliated and that for the purposes of this section a corporation was affiliated with one or more other corporations "when such corporation * * * owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others".

Section 240 of the Revenue Act of 1918 provided in substance that corporations which were affiliated should make a consolidated return, that the taxes imposed by that Act should be computed and determined upon the basis of such a return and that two or more domestic corporations should be deemed to be affiliated "if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others."

These sections of the Revenue Acts of 1921 and 1918 are printed in full in the appendix (pp. 19-20, *infra*).

The taxpayers contend that the American Gas and Electric Company owned or controlled substantially all the stock of the Atlantic City Electric Company within the meaning of the Revenue Acts, because it owned all the common stock of that company, and through that ownership had the power to redeem all the preferred stock of that company at any time. They contend in substance that the preferred stock of the Atlantic City Company should not be treated the same as if

it were common stock, because of the limited nature of its rights and interests in the company, that the preferred stock had no substantial interest in and bore no part of the burden of the taxes, that the common stock was substantially all of the stock within the meaning of the Revenue Acts, and in any case that the American Gas and Electric Company controlled the preferred stock through its power to redeem it at at any time.

The Commissioner contends, on the other hand, that the preferred stock of the Atlantic City Company should be treated the same as if it were common stock in spite of the limited nature of its rights and interests in the company, that the American Gas and Electric Company did not control the preferred stock within the meaning of the Revenue Acts even though it had the power to redeem it at any time, that the total number of the shares of the common stock was only 77% of the total number of the shares of the preferred and common stock taken together and that 77% of the total number of the shares was not substantially all of the stock.

Reasons for Allowing the Writ of Certiorari.

The reasons urged for allowing the writ of certiorari are:

1. That the Circuit Court of Appeals for the Second Circuit has rendered a decision in the case at bar which is in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in *Commissioner* v. *Shillito Realty Co.*, 39 Fed. (2nd) 830, and the decision of the Circuit Court of Appeals for the First Circuit in *Howes Brothers Hide Co.* v. *Burnet*, 49 Fed. (2nd) 878, on the same matter.

2. That the Circuit Court of Appeals for the Second Circuit has decided an important question of Federal law which has not been and should be settled by this Court.

Wherefore your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this

Honorable Court directed to the Circuit Court of Appeals for the Second Circuit commanding that Court to certify and to send to this Court for its review and redetermination on a day certain to be therein named a full and complete transcript of the record and all proceedings herein, and that the said decision of the Circuit Court of Appeals for the Second Circuit be reversed by this Honorable Court and that your petitioner may have such other and further relief in the premises as to this Honorable Court may seem meet and just and your petitioner will ever pray.

Respectfully submitted,

GRAHAM SUMNER,
Counsel for Atlantic City
Electric Company,
Petitioner.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

Opinion Below.

The opinion of the United States Board of Tax Appeals is reported in 15 B. T. A. 1084. The opinion of the Circuit Court of Appeals for the Second Circuit is reported in 57 Fed. (2nd) 186.

Jurisdiction.

The jurisdiction of this Court rests upon Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925 (Chap. 229, 43 Stat. 936). The date of the judgment of the Circuit Court of Appeals to be reviewed by Writ of Certiorari is April 11, 1932 (R. p. 33).

Statement of the Case.

A statement of the case, including the facts and contentions of the parties, is contained in the Petition for Writ of Certiorari.

Specification of Error to be Urged.

The Circuit Court of Appeals for the Second Circuit erred in holding that the taxpayers were not affiliated with the American Gas and Electric Company for the years 1917, 1918 and 1919, within the meaning of the Revenue Acts applicable to those years.

Argument.

The particular statutes involved in this case, including Section 1331 of the Revenue Act of 1921 and Section 240 of the Revenue Act of 1918, are printed in the appendix (pp. 19-20, *infra*).

These Revenue Acts provide two grounds for affiliation, (1) where one corporation owns or controls substantially all

the stock of another or others, and (2) when substantially all the stock of two or more corporations is owned or controlled by the same interests. The case at bar involves only the first ground, but most of the cases hereinafter cited involved the second ground. It has been generally held that the second ground is not satisfied unless the stock of two or more corporations is owned or controlled by the same interests *in like proportions.*

In *Commissioner* v. *Shillito Realty Co.,* 39 Fed. (2nd) 830 (C. C. A. Sixth Cir.), one corporation and its stockholders owned 6,000 shares, being all of the common stock, and 1,862 shares out of 6,000 shares of the preferred stock, of another corporation. Both classes of stock had voting power. The preferred stock was preferred as to dividends at the rate of 6% per annum and par on liquidation and was redeemable after a certain future date, at the option of the common stock at $105 per share. The result is that the first corporation and its stockholders owned 66% of all the stock of the other corporation and that the 34% not so owned was redeemable preferred stock. It was held that the two corporations were affiliated within the meaning of Section 240 of the Revenue Act of 1918.

Jones, District Judge, in delivering the opinion of the Court, said with reference to the preferred stock:

> "We think the term 'stock', as used in the statute, is clearly intended to mean stock with a potential voting power which, if asserted, will be effective in the management or control of the corporation. This preferred stock was so hedged with limitations that it was ineffective in respect to any control or domination. Its annual dividend of 6 per cent. was fixed. It was to be paid in full on liquidation, and was redeemable at the option of the store company, after 1924, for $105 per share. *The preferred stock bore no burden of taxation and exercised no voice in the management or policy of the company, nor did it have any hazards or benefits to be reckoned with in the return of income for taxation. Its redeemability gave it the color of indebtedness."* (Italics are ours.)

In *United States* v. *Cleveland P. & E. R. R. Co. Inc.*, 42 Fed. (2nd) 413 (C. C. A. Sixth Cir.), the Court, through Judge Mack, analyzed many decisions on the subject of affiliation and said with reference to the *Shillito* case:

> "*Commissioner of Internal Rev.* v. *John Shillito Co.*, 39 F. (2d) 830, decided by this court, April 10, 1930, presented a very different situation. There, the stock was one-half common and one-half preferred; here it was all of one class, common. There, though the preferred stock had voting rights, nevertheless the interest of the preferred stockholders in their corporation was fixed, certain, and unchangeable; it was unaffected by the relative tax liabilities of the two companies. Here, the rights of the minority stockholders could be and were materially affected thereby, as well as by the manner in which the majority interest could cause the two companies to deal with one another financially and otherwise. * * *"

In *Howes Brothers Hide Co.* v. *Burnet*, 49 Fed. (2nd) 878 (C. C. A. First Cir.), the question was whether three corporations, namely, the Howes Brothers Company, the Howes Brothers Hide Company and the Huntington Shoe & Leather Company, were affiliated within the meaning of the Revenue Act of 1918. Five Howes brothers owned all the common stock and all the second preferred stock of the Howes Brothers Company, amounting in the aggregate to 15,000 shares, and 37 out of 15,000 shares of redeemable first preferred stock. Every share had the same voting power. The five Howes brothers owned all the stock of the Hide Company. Two of the Howes brothers owned 115 shares out of 1,200 shares of stock of the Huntington Company. The other three Howes brothers owned no stock of this Company. One Sawyer, who was a nephew of one of the Howes brothers, held 680 shares of the stock of this Company, which had been purchased with funds advanced by the Hide Company either to Sawyer or to one of the Howes brothers or to both. The remainder of the stock of this Company belonged to friends, relatives or business associates of the Howes brothers. The

Huntington Company had an operating deficit and owed the Howes Brothers Company a large sum of money.

The Circuit Court of Appeals held that substantially all the stock of the three corporations was owned or controlled by the Howes brothers and that they were all affiliated within the meaning of the Revenue Act of 1918. Anderson, *C. J.*, in delivering the opinion of the Court, said at page 880:

> "Unquestionably, the Howes brothers are the dominant, managerial, and economic power of the three concerns. In common phrase, the Huntington Company and the hide company are subsidiaries of the Howes Brothers Company. The three concerns are a business unit.
>
> In business and in financial control they are clearly affiliated. Whether they are affiliated within the fair construction of the taxing statute is the only possibly doubtful question.
>
> Considering first the Huntington Company:
>
> Its stock is, to the extent of 1,035 shares out of 1,200 shares, owned by the Howes brothers or their entirely owned hide company. The Huntington Company is also largely in debt to the Howes Brothers Company and/or the hide company. We think it quite clear that the minority interests are, as this court held in *Kile & Morgan Co.* v. *Commissioner,* 41 F. (2d) 925, only negligible. Moreover, the minority stock is practically all held by relatives, at least by marriage, or employees.
>
> The main question is as to the minority holding of first preferred stock in the Howes brothers corporation. This company issued these callable preferred stocks in order to get more cash for their expanding and prosperous business. Both the A and B series are callable on 90 days' notice. None of the preferred stockholders have even attended a stockholders' meeting in person. They have either neglected the meetings, or given their proxies to some one of the Howes brothers. *Their practical business relation to the enterprise is very much like that of bondholders, at least during times of prosperity.* During the years in question, the Howes Brothers Company and the wholly controlled hide company, one or both, *could without apparent embarrassment have called all these preferred stocks and paid therefor out of available surplus.*

> It follows that, in a practical, financial, and business sense, the same interests controlled this corporation." (Italics are ours.)

The above statement that 1,035 shares out of 1,200 shares of the Huntington Company stock were owned by the "Howes brothers" or their entirely owned hide company is an obvious error. The actual holdings of the stock of the Huntington Company are set out in full in the first part of the opinion.

This decision was reversed by the Supreme Court without opinion, upon the authority of *Handy & Harman* v. *Burnet,* 284 U. S. 136 (284 U. S. 583).

In *Handy & Harman* v. *Burnet,* 284 U. S. 136, it was held that control of stock "resting solely on acquiescence, the exigencies of business or other considerations having no binding force" was not sufficient to satisfy the Revenue Act of 1918. This case did not involve the status of preferred stock. It involved only the status of stock held as security for a loan, that is, stock which a pledgee had the power to hold as security but which the pledgor had the power to redeem. It was held that the pledgee did not own or control the stock within the meaning of the Revenue Act.

Mr. Justice Butler in delivering the opinion of the Court, said at page 140:

> "The purpose of § 240 was, by means of consolidated returns, to require taxes to be levied according to the true net income and invested capital resulting from and employed in a single business enterprise, even though it was conducted by means of more than one corporation. Sub-section (b) clearly reflects the intention, by means of such returns, to secure *substantial equality as between shareholders who ultimately bear the burden.* That intention is shown by the legislative history and was given effect by the regulations contemporaneously promulgated. It requires no discussion to show that such returns will not make against inequality or evasion unless the same interests are the beneficial owners *in like proportions* of substantially all of the stock of each of such corporations. *Alameda Investment Co.* v. *McLaughlin,* 28 F. (2d) 81. *Montana Mercantile Co.* v. *Rasmusson,*

28 F. (2d) 916. *Commissioner* v. *Adolph Hirsch & Co.*, 30 F. (2d) 645, 646. *Commissioner of Internal Revenue* v. *City Button Works*, 49 F. (2d) 705. Affiliation on any other basis would not make against inequality or evasion. It would require very plain language to show that Congress intended to permit consolidated returns to depend on a basis so indefinite and uncertain as *control of stock without title, beneficial ownership or legal means to enforce it. Control resting solely on acquiescence, the exigencies of business or other considerations having no binding force is not sufficient to satisfy the statute.*" (Italics are ours.)

The important question in the *Howes Brothers* case was not whether the Howes Brothers Company and the Hide Company (both of which had net incomes) were affiliated, but whether the Huntington Company (which had a loss) was affiliated with the other two companies, and no Court could hold that the Howes brothers owned or controlled more than ten per cent of the stock of the Huntington Company, unless it held that "control resting solely on acquiescence, the exigencies of business or other considerations having no binding force" was sufficient to satisfy the statute. With respect to ninety per cent of the stock of the Huntington Company the Howes brothers had no "title, beneficial ownership or legal means to enforce" any kind of control. Furthermore, the interests of the individual Howes brothers were different with respect to each company, and it could not possibly be held that substantially all the stock of the three companies was owned or controlled by the same interests *in like proportions.*

The decision in the *Handy & Harman* case required a reversal of the *Howes Brothers* case without reference to the status of the redeemable preferred stock of the Howes Brothers Company, a point which was not involved in the *Handy & Harman* case. The inference is that the Supreme Court did not intend to decide any point in the *Howes Brothers* case which it had not decided in the *Handy & Harman* case, and that it did not intend to pass upon the status of the redeemable preferred stock of the Howes Brothers Company.

The regulations to which the Supreme Court referred in the *Handy & Harmon* case include Regulation 45, 1920 Ed., Articles 631 and 633, which are quoted in full in the appendix (*Infra,* pp. 20-1). Article 631 states that the provision of the Act of 1918 requiring affiliated corporations to file consolidated returns "is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise even though the business is operated through more than one corporation", and points out that when corporations are affiliated there is a risk of evasion of taxation or excessive taxation due to the shifting of income from one corporation to another because of intercorporate dealings which might be arbitrary or artificial, and that the purpose of a consolidated return is to determine accurately the total invested capital and total net income, regardless of such intercorporate dealings. Article 633 states specifically that "the words 'substantially all the stock' cannot be interpreted as meaning any particular percentage but must be construed according to the facts in the particular case", that consolidated returns are required in all cases where the stock ownership or control is ninety-five per cent. or more and that consolidated returns may be required in cases where the stock ownership or control is less than ninety-five per cent. but in excess of fifty per cent.

It is obvious that Congress did not undertake to define the word "control" or the words "substantially all", because it recognized that there might be different methods of controlling stock and different classes of stock, and that the requirement for consolidated returns should not depend upon the ownership or control of a fixed percentage of the total number of outstanding shares. If Congress had intended that the matter should be determined by a fixed percentage of the total number of outstanding shares regardless of the character of the shares, it presumably would have said so in so many words. When there are two or more classes of stock, it is obvious that a share of one class may count for more or less than a share of another class in determining what constitutes substantially all of the stock.

It has frequently been recognized that the words "substantially all the stock" do not mean a fixed percentage of all the outstanding shares.

Reg. 45, Arts. 631 and 633.

Temtor Corn & Fruit Products Co., Inc., In re, 299 Fed. 326; affirmed *Schlafly* v. *United States* (C. C. A. 8th), 4 F. (2nd) 195.

U. S. v. *Whyel,* 19 F. (2nd) 260.

Great Lakes Hotel Company v. *Commissioner,* (C. C. A. 7th), 30 F. (2nd) 1.

Commissioner v. *Shillito Realty Co.* (C. C. A. 6th), 39 F. (2nd) 830.

Commissioner v. *Adolph Hirsch & Co., Inc.* (C. C. A. 2d), 30 F. (2nd) 645.

It is important to note in the present case not only that the preferred stock of the taxpayer was redeemable at any time at the option of the American Gas and Electric Company as the owner of all the common stock, but also that the ownership of the common stock carried substantial ownership as well as control of the business conducted by the taxpayer. The preferred stock was preferred only as to dividends at the rate of 6% per annum and on final liquidation. The holder of the common stock owned the equity, including all the capital and surplus subject to these limited rights of the preferred stockholders. The dividends payable upon the preferred stock of the taxpayer amounted to only $22,200 per annum, whereas the income for the taxable years averaged more than $152,000, about seven times the dividend requirements.

In the *Handy & Harman* case the Supreme Court clearly indicated that the object of a consolidated return was to counteract the effect of intercompany arrangements, whether fortuitous or deliberate, which would distort the true tax liability of the enterprise by allotting a disproportionate share of the income or expenses to one or more of the constituent companies. As the purpose of this was to secure

equality "as between shareholders who ultimately bear the burden", we submit that only such shareholders should be counted, and that shareholders whose interests are not affected by intercompany arrangements, and whose portion of the income is not affected by an increase or a decrease in the amount of the taxes, should not be counted.

When the dividends payable to the preferred stockholders are limited in amount and are earned many times over and the common stockholders are entitled to all the earnings in excess of the preferred dividends, it is clear that the common stockholders are the only ones who are affected by intercorporate dealings, and the only ones who *bear the burden of the Federal taxes.* Arbitrary or artificial arrangements for distributing income or expenses between affiliated companies do not increase or decrease the amount of the income to which such preferred stockholders are entitled, and whether the taxes are large or small not one particle of the burden of the taxes is borne by them. In such cases the preferred stockholders are more like creditors than stockholders, particularly when the preferred stock is redeemable at the option of the common stockholders and the preferred stockholders may thus be required at any time to surrender all interest in the business.

We accordingly submit that the common stock of the Atlantic City Company was substantially all the stock of that Company within the meaning of the Revenue Acts, as interpreted by the Supreme Court and the regulations approved by the Supreme Court, and that for the purpose of determining the question of affiliation the preferred stock should be classed as a debt rather than as stock. We further submit that the power to redeem the preferred stock carried control of that stock within the meaning of the Revenue Acts as so interpreted. This control did not rest upon acquiescence or exigencies of business. It had "binding force" and the American Gas and Electric Company had "legal means to enforce it."

The Revenue Acts use both the word "own" and the word "control", and it is obvious that the word "control" means something less than the word "own". It is not necessary for

purposes of affiliation that one corporation should "own" substantially all the stock of another. It is enough if one corporation "owns *or* controls" substantially all the stock of the other. That the power to redeem and extinguish stock at any time carries control over the stock can hardly be doubted.

It has been held or clearly indicated that an option to purchase stock carries control within the meaning of the Revenue Acts.

Pelican Ice Co. Ltd. v. *Commissioner,* 37 Fed. (2nd) 285 (C. C. A. 5th Cir.);

Continental Products Co. v. *U. S.,* 44 Fed. (2nd) 257 (Ct. of Claims) certiorari denied 51 Sup. Ct. Rep. 352.

It was held in *Handy & Harman* v. *Burnet, supra,* that 75% of the stock of a corporation *all of one class* did not constitute substantially all of its stock. There may not be much difference between 75% and 77%, although it is obvious that something less than 100% would constitute substantially all the stock. The regulations clearly indicate that in some cases 51% of the stock might constitute substantially all of the stock, and it seems clear that the question as to what percentage would constitute substantially all the stock must depend upon the particular facts of particular cases, interpreted in the light of the fundamental purpose of the provisions of the Revenue Acts with respect to affiliation.

If one corporation owns 77% of all the outstanding shares of stock of another corporation, it seems obvious that the question whether they are affiliated must depend upon the character of the shares which are not owned, that is, upon the relative rights and interests of the parties with respect to the business and assets of the controlled company. If the two corporations formed in substance a single business enterprise or if the interests and rights of the controlling corporation were such as to enable it to manage the affairs of the controlled corporation substantially as if it were the owner of its business and assets, it seems clear that the two

corporations would be affiliated within the meaning of the Revenue Acts.

There is no doubt that the American Gas and Electric Company and the Atlantic City Company formed a single business enterprise and no doubt that the American Gas and Electric Company had power to manage, and did manage, the affairs of the Atlantic City Company exactly as if it were the absolute owner of its business and assets.

The claim that these two corporations were not affiliated within the meaning of the Revenue Acts because of the mathematical relation between the number of the shares of the preferred stock and the number of the shares of the common stock seems to us wholly artificial. Without contributing any additional capital, but merely by splitting up the common stock, that is, by reducing the par value and increasing the number of the shares, the American Gas and Electric Company could have increased the number of the common shares many times over the number of the preferred shares, without changing in any way the relative interests of the preferred and common stockholders in the enterprise, and yet if the number of the shares of the common stock had been 95% of the total number of the shares of the preferred and common stock taken together, the Commissioner would have conceded that the two corporations were affiliated within the meaning of the Revenue Acts.

Conclusion.

We submit that the taxpayers were affiliated with the American Gas and Electric Company within the meaning of the Revenue Acts and that the decision of the Circuit Court of Appeals should be reversed upon the merits.

We further submit that the decision of the Circuit Court of Appeals is in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in *Commissioner* v. *Shillito Realty Co., supra,* and the decision of the Circuit Court of Appeals for the First Circuit in *Howes Brothers*

Hide Co. v. *Burnet, supra.* It seems clear that the two Courts last mentioned would have held that the American Gas and Electric Company owned or controlled all the stock of the taxpayers.

We further submit that the questions decided by the Circuit Court of Appeals in the case at bar are important questions of Federal law which have not been and should be settled by the Supreme Court. There is no case in which the Supreme Court has passed upon the status of preferred stock in connection with the matter of affiliation. The Supreme Court has never decided whether preferred stock should be treated the same as if it were common stock, or whether the nature of its rights and interests as compared with those of the common stock should be taken into consideration, or whether the power to redeem preferred stock carries control of the stock within the meaning of the Revenue Acts. These questions involve the interpretation of the words "substantially all" and the word "control" as used in the Revenue Acts. They are questions of general application which presumably would affect the tax liability of many other corporations.

Respectfully submitted,

GRAHAM SUMNER,
Counsel for Atlantic City
Electric Company,
Petitioner.

COURTLAND KELSEY,
CHARLES F. MCISAAC,
Counsel.

Appendix.

REVENUE ACT OF 1921, C. 136, 42 STAT. 227

SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

(b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided*, That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus affecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. For the purposes of this section, public-service corporations which (1) were operated independently, (2) were not physically connected or merged, and (3) did not receive special permission to make a consolidated return, shall not be construed to have been affiliated; but a railroad or other public utility which was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated return, shall be construed to have been affiliated.

(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

REVENUE ACT OF 1918, C. 18, 40 STAT. 1057

SEC. 240. (a) That corporations which are affiliated within the meaning of this section shall, under regulations to be prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income and invested capital for the purposes of this title and title III, and the taxes thereunder shall be computed and determined upon the basis of such return * * *.

(b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

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ART. 631. *Affiliated corporations.*—The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and net income of the branch form a part of the invested capital and net income of the entire organization. Where such branches or units of a business are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through

price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group. See articles 785, 791, 802, and 864-869.

ART. 633. *When corporations are affiliated.*—Corporations will be deemed to be affiliated (*a*) when one domestic corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (*b*) when substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. The words "substantially all the stock" can not be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95 per cent or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required even though the stock ownership is less than 95 per cent. When the stock ownership or control is less than 95 per cent, but in excess of 50 per cent, a full disclosure of affiliations should be made, showing all pertinent facts, including the stock owned or controlled in each subsidiary or affiliated corporation and the percentage of such stock owned or controlled to the total stock outstanding. Such statement should preferably be made in advance of filing the return, with a request for instructions as to whether a consolidated return should be made. In any event such a statement should be filed as a part of the return. The words "the same interests" shall be deemed to mean the same individual or partnership or the same individuals or partnerships, but when the stock of two or more corporations is owned or controlled by two or more individuals or by two or more partnerships a consolidated return is not required unless the percentage of stock held by each individual or each partnership is substantially the same in each of the affiliated corporations.

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CHARLES ELMORE

No. 163.

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1932.

ATLANTIC CITY ELECTRIC COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR PETITIONER.

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IN THE

Supreme Court of the United States.

OCTOBER TERM—1932.

No. 163.

ATLANTIC CITY ELECTRIC COMPANY,
Petitioner,

AGAINST

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF FOR PETITIONER.

The petitioner relies for its main brief herein upon the brief filed in support of its petition for a writ of certiorari and begs leave to file this brief in answer to the brief of the respondent. Since the petition for certiorari was filed the record herein has been reprinted. The findings of fact made by the Board of Tax Appeals showing the relations between the American Gas and Eelctric Company and the taxpayers are printed at pages 15 to 19, and the stipulation of counsel showing the amounts of the net incomes of the taxpayers during the taxable years is printed on page 33 of the record as reprinted.

I.

The American Gas and Electric Company owned or controlled all or substantially all the stock of the taxpayers.

The changes which Congress has made in the Revenue Acts with reference to the use of consolidated returns do not seem to us to help the respondent. The Revenue Act of 1921 (Sec. 240) gave to affiliated corporations the option

to make separate returns or a consolidated return for taxable years beginning on or after January 1, 1922, but it left the test of affiliation the same as in the Revenue Act of 1918. For the years 1917 to 1921 during which the excess profits tax was in force, affiliated corporations were required to make consolidated returns, but for the years after 1921 when only the income tax was in force, affiliated corporations were permitted to make either separate returns or a consolidated return.

The Revenue Act of 1924 (Sec. 240) changed the test of affiliation from *ownership or control* of *substantially all* the stock to *ownership* of at least *95 per centum* of the *voting* stock. The Revenue Act of 1926 (Sec. 240) changed the test of affiliation to ownership of at least 95 per centum of the stock, but provided that the term "stock" should not include "non-voting stock which is limited and preferred as to dividends".

The Revenue Acts of 1928 and 1932 (Sec. 241) eliminated as a test of affiliation the ownership of stock by individuals and limited the test to the ownership of stock directly or indirectly by a corporation.

There is no doubt that these changes in the wording of the law indicate an intention on the part of Congress to change the substance of the law rather than to interpret a prior law. They do not furnish any ground for the argument that the words "substantially all the stock" as used in the Revenue Acts for 1917 and 1918 meant 95 per centum of the stock. They tend on the contrary to show that the words "substantially all the stock" as used in the earlier acts meant something less than 95 per centum of the stock. They show an intention to make the test of affiliation more definite than it had been and recognize that the test laid down in the Revenue Acts for 1917 and 1918 was broad and flexible.

The respondent argues that 77 per cent of the stock of a corporation is not substantially all of its stock within the meaning of the Revenue Acts for 1917 and 1918 but does not indicate what percentage would be substantially all of its stock within the meaning of those statutes.

The respondent also argues that it makes no difference whether the outstanding stock of the subsidiary corporation is preferred or limited as to dividends or redeemable at the option of the parent corporation, and that the word "stock" as used in these statutes includes every kind of voting stock but no kind of non-voting stock. There may be cases where the question whether the outstanding stock has voting power would have a bearing upon the matter of consolidation for tax purposes, but we cannot see how it makes any difference in this case whether the preferred stock of the taxpayers had voting power or not. The American Gas and Electric Company had the absolute power to elect the entire Board of Directors of each of the taxpayers and thus to control every detail of management. The power of the preferred stockholders to vote did not increase in any way their interest in intercorporate dealings or their right to question them.

Furthermore, if it is possible to construe these statutes so as to eliminate from consideration non-voting stock, we submit that it is equally possible to construe them so as to eliminate from consideration limited and redeemable preferred stock.

The respondent seems to recognize that the purpose of these statutes was to secure substantial equality as between the stockholders who bore the burden of the taxes and to prevent the evasion of taxes through arbitrary intercorporate dealings and that Articles 631 and 633 of Regulations 45 of the Treasury Department were valid and appropriate to carry out this purpose. The respondent argues, however, that the preferred stockholders of the taxpayers did bear some part of the burden of the taxes and that the existence of this stock was an effective check against diversions of income through price fixing, charges for services or other arbitrary intercorporate dealings.

The figures show convincingly that the preferred stockholders of the taxpayers bore no part of the burden of the taxes. In the case of the Atlantic City Company the net income for the years 1917 to 1919 averaged more than

$152,000, the taxes for these years as assessed by the Commissioner upon the basis of separate returns and before they were reduced by the Board of Tax Appeals averaged only $18,714, and the preferred dividend requirements amounted to only $22,200 per annum. In the case of the Scranton Company the net income for the years 1917 to 1919 averaged more than $610,000, the taxes for those years as assessed by the Commissioner upon the basis of separate returns, and before they were reduced by the Board of Tax Appeals averaged only $126,365, and the preferred dividend requirements amounted to only $64,200 per annum (R. pp. 15-16, 33). It is obvious that the preferred stockholders had no practical interest in the amount of the Federal taxes.

These figures also show convincingly that the preferred stockholders had no interest in any diversions of income which the American Gas and Electric Company might have made through price fixing, charges for services or other intercorporate dealings. The American Gas and Electric Company was entitled to all the earnings of the taxpayers in excess of the dividends upon their preferred stock, and it did not make any difference to the preferred stockholders whether the American Gas and Electric Company received these excess earnings through the declaration of dividends upon the common stock or through price fixing, charges for services or other intercorporate dealings. The preferred stockholders would have no interest in such dealings and no reason to take notice of them unless they involved a diversion of the greater part of the earnings and thus threatened the safety of their dividends. The plain fact is that the existence of this preferred stock was not an effective check or any kind of a check against the evasion of taxes through intercorporate dealings. If the American Gas and Electric Company had desired to do so, it could have diverted by intercorporate dealings one-half or three-quarters of the incomes of the taxpayers before the preferred stockholders would have been moved to take any action to interfere with such dealings.

We contend that the test of affiliation laid down in the Revenue Acts for 1917 and 1918 was broad and flexible, that it should be interpreted in the light of the purpose of the statutes, and that under such an interpretation the common stocks of the taxpayers were substantially all their stocks.

Our contentions are fully supported by Sections 631 and 633 of Regulations 45 of the Treasury Department which have received not only the sanction of the Respondent, but also that of the Supreme Court. It was stated in *Handy & Harman* v. *Burnet,* 284 U. S. 140, that the purpose and intention of the statutes in question "was given effect by the regulations contemporaneously promulgated," including specifically Articles 631 and 633 of Regulations 45.

Article 633 of Regulations 45 states specifically that the words "substantially all the stock" cannot be interpreted as meaning any particular percentage but "must be construed according to the facts of the particular case," that consolidated returns may be required even though the stock ownership or control is less than 95 per cent., and that when the stock ownership or control is less than 95 per cent. but in excess of 50 per cent., a full disclosure of the facts must be made. There could be no purpose in such a disclosure other than to enable the Commissioner to determine the question of affiliation according to the facts of the particular case. These provisions show clearly enough that in some particular cases the words "substantially all the stock" might mean any percentage in excess of 50 per cent.

As the fundamental purpose of the statutes as stated in Article 631 of the Regulations, and the opinion of the Supreme Court in *Handy & Harman* v. *Burnet, supra,* and as conceded by the respondent in his brief, was to determine the true net income and invested capital of a single business enterprise, even though the business was operated through more than one corporation, and to prevent inequalities or evasions which might result from price fixing, charges for services or other intercorporate dealings, it is obvious that

a parent corporation is always affiliated with a subsidiary corporation within the meaning of these statutes, unless the outstanding stock of the subsidiary is of such a quantity and such a character as to be an effective check against such intercorporate dealings. When the outstanding stock is common stock and of the same class as that held by the parent, a relatively small amount of it might be an effective check, but when the outstanding stock is only preferred stock which is limited as to dividends and redeemable at the option of the parent, and the earnings of the subsidiary exceed its preferred dividend requirements many times over, no amount of such stock would be an effective check.

The preferred stocks of the taxpayers were high grade investment stocks. They appealed to investors who were looking for safety of principal and safety of income and did not want to be bothered with questions of management. The holders of this stock had no power to elect a single director or take any part in the management.

The ownership of the common stock gave the American Gas and Electric Company the power to elect all the directors and absolute control over the business and management of the taxpayers. The record shows that it actually supervised and regulated the details of the business. The officers and directors of the three companies were practically the same individuals and the taxpayers did nothing of any importance without the approval of the American Gas and Electric Company. The preferred stockholders never made any objection to anything that was done (R. pp. 17-18).

We contend that the common stock of the taxpayers was substantially all their stock within the meaning of the Revenue Acts and that the ownership of this common stock by the American Gas and Electric Company was enough to constitute an affiliation, without reference to whether the power to redeem the preferred stocks carried control over those stocks within the meaning of the Revenue Acts. We submit,

however, that the power to redeem did carry control over those stocks within the meaning of the Revenue Acts.

It may be conceded that until the power to redeem is exercised, the owners of the stock have the right to sell or otherwise dispose of it and to collect dividends and to vote thereon as freely as any other owners. It is true, nevertheless, that the power to redeem carries control over the stock. It includes power to take the stock away from the owners at any time and put it out of existence. This power is conferred by the charter and inherent in the stock. It is hard to see how any one person could have any more effective control over stock which belonged to another. It is true, of course, that it carries no beneficial ownership but the Revenue Acts for 1917 and 1918 did not make ownership the test of affiliation. They provided specifically that two corporations were affiliated if one owned or controlled substantially all the stock of the other.

The record shows that these preferred stocks were redeemable at any time by vote of the common stock, that the American Gas and Electric Company owned the common stocks of thirty or forty different lighting and power companies, that the par value of the preferred stocks of the taxpayers amounted to only $1,440,000 (R. pp. 16-17) and that the net incomes of the taxpayers for the three taxable years exceeded $2,288,000 (R. p. 33). There is no ground for the inference that the American Gas and Electric Company was not in a position to redeem these preferred stocks if it had desired to do so.

The case of *Peytona Lumber Co.* v. *Commissioner,* cited by the Respondent is not in point. In that case, H and M each owned 50% of the stock of one corporation. Prior to its organization they agreed orally that the management should be left to M and that M might at any time acquire the stock of H at cost plus interest. M owned or controlled substantially all the stock of another corporation. It was held that the two corporations were not affiliated. It does not appear that the stock covered by the option was delivered to M or deposited in any way under the option. The decision is based

upon the ground that M had no control of H's stock enforcible at law or otherwise and that the same interests were not "the beneficial owners in like proportions of substantially all the stock of each of said corporations", within the language of the Supreme Court in the *Handy & Harman* case. It is obvious that an option to acquire stock which is not deposited with or for the benefit of the optionee is very different from a right to redeem stock under a charter provision. Under such an option the right of the optionee may be defeated by a sale of the stock to an innocent purchaser for value and the nature of the control is temporary and incomplete. Under such a charter provision the right to redeem is binding upon all holders whether they acquired the stock with or without notice and the nature of the control is permanent and complete. Such a right to redeem affects the inherent nature of the stock itself.

It is important throughout to note the differences between the two grounds for affiliation which are contained in the Revenue Acts, the first applying when one corporation owns or controls substantially all the stock of another or others, and the second applying when substantially all the stock of two or more corporations is owned or controlled by the same interests. The case at bar involves the first ground, but the *Handy & Harman* case, the *Howes Brothers* case and the *Peytona Lumber* case involved the second ground. When affiliation depends upon the second ground the statute is not satisfied unless the same interests own or control substantially all the stock of the corporations *in like proportions*. It is obvious that this requirement was not satisfied in the *Handy & Harman* case, the *Howes Brothers* case or the *Peytona Lumber* case and that it is not applicable to the case at bar.

II.

This case does not fall within the exception of the Revenue Act for 1917 relating to public service corporations.

It is a well established rule that an exception in a statute should be construed strictly, that such an exception takes no case out of the enacting clause which does not fall fairly within its terms and that a party who claims the benefit of such an exception has the burden of proving that his case falls within its terms.

> *U. S.* v. *Dickson,* 15 Pet. 141;
> *Schlemmer* v. *Buffalo R. & P. Ry. Co.,* 205 U. S. 1;
> *Baltimore & O. S. W. R. Co.* v. *U. S.,* 242 Fed. 420;
> *Thompson* v. *United States,* 258 Fed. 196;
> *Hopkins* v. *U. S.,* 235 Fed. 95.

In *Schlemmer* v. *Buffalo R. & P. Ry. Co., supra,* Mr. Justice Holmes said:

> "'The general rule of law is, that a proviso carves special exceptions only out of the body of the act; and those who set up any such exception must establish it,' etc. *Ryan* v. *Carter,* 93 U. S. 78, 83. *United States* v. *Dixon,* 15 Peters, 141, 165. The rule applied to construction is applied equally to the burden of proof in a case like this. *United States* v. *Cook,* 17 Wall. 168; *Commonwealth* v. *Hart,* 11 Cush. 130, 134."

It follows that the respondent has the burden of proving that this case falls within the exception in Section 1331 of the Revenue Act of 1921. The respondent also has the burden of showing that the decision of the Board of Tax Appeals was wrong. The result is that if the record does not contain the facts necessary to show that this case falls

within the exception in Section 1331, it must be held that it does not fall within the exception.

The contentions now made by the Respondent with respect to the exception in Section 1331 were not made before the Board of Tax Appeals or considered by that Board. No such contention is suggested by the assignments of error, which relate only to the question whether the Atlantic City Company or the Scranton Company was affiliated with the American Gas and Electric Company for the three taxable years (R. pp. 27-8).

The record shows that the American Gas and Electric Company was a holding corporation and not a public service corporation (R. pp. 16-7). It also shows that the taxpayers were not operated independently of the American Gas and Electric Company. The operations of the former were controlled by the latter (R. pp. 17-8).

The record shows that the Atlantic City Company was formed by the consolidation of several lighting, heating and power companies operating in and around Atlantic City, and that the Scranton Company was formed by the consolidation of several lighting, heating and power companies operating in and around Scranton. It does not show specifically that either of these companies was a public service corporation and certainly does not show that they were operated independently or that they were not physically connected (R. 16-8).

The record shows that the American Gas and Electric Company was the owner of all the common stock, including a majority of the voting stock, of from thirty to forty lighting and power companies in the Atlantic and Middle states, including the Atlantic City Company and the Scranton Company (R. 16-7). The inference is that the American Gas and Electric Company operated all these companies in harmony with each other and as economically as it could. They were all parts of one system or enterprise and it is obvious that harmonious operation and physical connection would be economical and otherwise advantageous. It is

entirely possible that some of these corporations were located between Scranton and Atlantic City and that they were all connected physically by transmission lines or otherwise so that they could make exchanges of power and other facilities according to their varying needs.

Even if it were assumed that the Scranton Company and the Atlantic City Company were operated independently and were not physically connected, it would not follow that this case fell within the exception of the statute. The question involved here is not whether these two corporations were affiliated with each other but rather whether they were affiliated with the American Gas and Electric Company. This was recognized throughout the opinion of the Board of Tax Appeals and the petition for review (R. 25-8). There are two separate cases, one between the Respondent and the Scranton Company and the other between the Respondent and the Atlantic City Company, each one involving separately the question whether the taxpayer in that case was affiliated with the American Gas and Electric Company.

It is clear that the exception in the statute applies only to the affiliation of two or more public service corporations *with each other,* and that it does not apply to the affiliation of such a corporation with *some other corporation* which owns or controls it. Any other interpretation would lead to an absurd result. Suppose, for instance, that it were held that the Atlantic City Company and the Scranton Company were not affiliated with each other, although each was affiliated with the American Gas and Electric Company, and that they could not both be included in a group with the American Gas and Electric Company for tax purposes, how could anybody determine which one should be included and which one excluded? Each would have the right to claim the benefit of affiliation with the American Gas and Electric Company and the Commissioner certainly would have no power to determine arbitrarily that one should have such benefit and the other not.

It should be noted that the exception in the statute applied only in cases where public service corporations (1) were operated independently, (2) were not physically connected or merged, AND (3) did not receive special permission to make a consolidated return. In order to bring this case within the exception, it is necessary for the Respondent to show that all three of these conditions existed. It is not enough for him to show that some one of them existed. The form of the exception is conjunctive and not disjunctive.

III.

The decision of the Circuit Court of Appeals should be reversed and that of the Board of Tax Appeals should be affirmed.

GRAHAM SUMNER,
COURTLAND KELSEY,
Counsel for Taxpayers.

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No. 163

In the Supreme Court of the United States

OCTOBER TERM, 1932

ATLANTIC CITY ELECTRIC COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 12–19) is reported in 15 B. T. A. 1084. The opinion of the Circuit Court of Appeals (R. 29–33) is reported in 57 F. (2d) 186.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 11, 1932. (R. 33.) The petition for a writ of certiorari was filed June 17, 1932. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Were the petitioner and the American Gas and Electric Company affiliated corporations during the years 1917, 1918, and 1919, within the meaning of Section 240 (b) (1) of the Revenue Act of 1918 and Section 1331 (b) (1) of the Revenue Act of 1921, when all of the petitioner's common stock, constituting 77 per cent of its total outstanding stock, was owned directly by the American Gas and Electric Company and the balance of its stock, being preferred stock with voting rights and redeemable at any time, was owned by outside interests?

STATUTES AND REGULATIONS INVOLVED

These are set forth in the appendix, pp. 11–13, *infra.*

STATEMENT

The findings of fact made by the Board of Tax Appeals (R. 13–15) may be summarized as follows:

During the taxable years 1917, 1918, and 1919, and for many years prior thereto, the American Gas and Electric Company was a holding corporation owning common stock in a number of lighting and power companies. (R. 13.) It had in excess of 3,000 stockholders. (R. 14.)

The petitioner is a public service corporation organized under the laws of New Jersey and engaged in the business of supplying light, heating, and power in and around Atlantic City, New Jersey. During the taxable years in question it had out-

standing 12,500 shares of common stock of $100 par value each, all of which were owned by the American Gas and Electric Company, and 3,702 shares of preferred stock, none of which were owned by the American Gas and Electric Company, although from 655 to 761 of such shares were owned by stockholders of the American Gas and Electric Company.[1] The common stock owned by the American Gas and Electric Company constituted about 77 per cent of the total outstanding common and preferred stock of the petitioner. Holders of the preferred stock were entitled to vote and such stock was preferred to the extent of an annual cumulative dividend of 6 per cent and on final liquidation. It was redeemable at any time and had no other interest in dividends above 6 per cent. (R. 13.)

In no instance during the years in question did any holder of preferred stock vote against or object to any action taken at any stockholders' or directors' meeting of the petitioner, nor against any proposition advanced by the American Gas and

[1] The stockholders in the American Gas and Electric Co. who owned some of the preferred stock in the petitioner must be taken as "outside interests." Obviously their holdings in the two corporations were not "in like proportions." Petitioner concedes that the case does not involve the question of ownership or control *by the same interests* (Br. 8), and the Board found (R. 14) that "the control and ownership exercised by the American Gas and Electric Co. resulted from its absolute ownership of the entire common stock of its subsidiaries and not from control or ownership of preferred stock by its stockholders."

Electric Company or its representatives, but voted in conformity thereto. Dividends on the preferred stock in the contract amount of 6 per cent were always paid promptly and there have never been any unpaid cumulative dividends. (R. 14.)

All financial matters and operations of the petitioner were conducted by and carried on through the American Gas and Electric Company and the major operations of the petitioner were carried on in the office of the American Gas and Electric Company at New York City. (R. 14.)

The respondent determined deficiencies against the petitioner for the taxable years in question on the basis of separate returns and refused to consolidate the returns of petitioner with those of the American Gas and Electric Company. (R. 13.) The Board of Tax Appeals held that the two corporations were affiliated and should file consolidated returns. (R. 16.) The Commissioner appealed (R. 29) and the Circuit Court of Appeals reversed the Board (R. 33).

ARGUMENT

The sole question is whether the American Gas and Electric Company owned or controlled, during the years 1917, 1918 and 1919, substantially all of petitioner's stock within the meaning of Section 1331 (b) (1) of the Revenue Act of 1921 and Section 240 (b) (1) of the Revenue Act of 1918, (*infra*, pp. 11–12).

The American Gas and Electric Company owned directly all of petitioner's common stock, which was only 77 per cent of its total outstanding stock. This was not "substantially all" within the meaning of the statute. In *Handy & Harman* v. *Burnet*, 284 U. S. 136, it was held that 76.66 per cent did not constitute "substantially all" and it has been held that 88 per cent (*Good Mfg. Co.* v. *Burnet*, 58 F. (2d) 685 (App. D. C.)), 85 per cent (*Burnet* v. *Bank of Italy*, 46 F. (2d) 629, 630 (C. C. A. 9th)), 77 per cent to 84 per cent (*United States* v. *Cleveland, P. & E. R. Co.*, 42 F. (2d) 413 (C. C. A. 6th)), 83⅓ per cent (*Jos. Denunzio Fruit Co.* v. *Commissioner*, 49 F. (2d) 41 (C. C. A. 6th)), and 80 per cent (*Wadhams & Co.* v. *United States*, 67 Ct. Cls. 235), did not constitute "substantially all" the stock of a corporation.

But the petitioner contends that the American Gas and Electric Company owned all the stock of the petitioner because it owned all the *common* stock of that company, and that the outstanding stock not owned by the American Gas and Electric Company should not be considered since it was all *preferred* stock with no interest in the earnings above annual dividends of 6 per cent. But the statutes involved refer to ownership or control of *stock* and make no distinction between preferred and common stock. The outstanding preferred stock here in question had voting privileges. (R. 13.) The applicable Regulations of the Treasury

Department (Article 633, Regulations 45 and 62, pp. 12–13, *infra*) have construed the statutes as referring to all outstanding *voting stock*. This interpretation has received legislative approval in Section 240 (c)(1) of the Revenue Act of 1924, c. 234, 43 Stat. 253, 288 (U. S. C., Title 26, Sec. 993) which section, in reenacting the statutes here involved, provides that two corporations are deemed affiliated "if one corporation owns at least 95 per centum of the *voting* stock of the other." (Italics ours.) The Report of the Committee on Ways and Means, referring to this provision, states (House Rept. No. 179, 68th Cong., 1st. Sess., p. 24):

> The requirement that the stock held must be "voting" stock merely embodies in the law the present rule of the Treasury Department.

See also Section 240 (c) and (d) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 46 (U. S. C. Sup. V, Title 26, Sec. 993). Moreover, the cases hold that the earlier Acts related to voting stock. *Schlafly* v. *United States,* 4 F. (2d) 195, 200, 201 (C. C. A. 8th); *Ice Service Co.* v. *Commissioner,* 30 F. (2d) 230 (C. C. A. 2d); *United States* v. *Cleveland, P. & E. R. Co.,* 42 F. (2d) 413, *supra.* Cf. *Commissioner* v. *City Button Works,* 49 F (2d) 705 (C. C. A. 2d).

In *Howes Bros. Hide Co.* v. *Commissioner,* 49 F. (2d) 878 (C. C. A. 1st), the court held that where the same interests owned directly all the common stock of two corporations affiliation could not be

denied merely because outside interests owned a substantial block of voting preferred stock in one of the corporations. But that decision was reversed by this Court *per curiam* on the authority of its decision in the *Handy & Harman* case, *supra,* 284 U. S. 583.

Petitioner contends that the reversal by this Court in the *Howes Bros. Hide* case was because the same interests did not hold the stock of the corporations there involved in like proportions—a requisite which is established by the *Handy & Harman* decision, *supra.* It is true that the facts in the *Howes Bros. Hide* case do show that the same interests did not hold the shares of the corporations involved in like proportions, but that point was not discussed by the Circuit Court of Appeals in its opinion nor was it raised in the Government's petition for certiorari. In the *Howes Bros. Hide* case, as said by the Circuit Court of Appeals (49 F. (2d) 878, 880), "The main question is as to the minority holding of first preferred stock in the Howes brothers corporation," and the decision was based on that point. The Government's petition for certiorari dealt chiefly with that question as did likewise the brief in opposition. While the decision in the *Handy & Harman* case did not involve the precise question raised in the *Howes Bros. Hide* case or in this case, we are unwilling to assume, as urged by petitioner, that this Court reversed the *Howes Bros. Hide* case on a point not passed upon by the Circuit Court of Appeals and not raised in the petition for certiorari.

If the reversal was based upon the chief issue actually raised, that case disposes of all questions presented in this case.

The only other decision holding that voting preferred stock should not be taken into account in determining the application of the statutory provisions here involved is *Commissioner* v. *Shillito Realty Co.*, 39 F. (2d) 830 (C. C. A. 6th.) But, as pointed out in the later decision by the same court in *United States* v. *Cleveland, P. & E. R. Co.*, 42 F. (2d) 413, 419, *supra*, that case went off on its own peculiar facts. The latter case is in conformity with the decision below and, we submit, eliminates any conflict between the decision in the instant case and the rulings of the Sixth Circuit. In any event, the *Shillito* case was decided prior to this Court's decision in the *Howes Bros. Hide* case, *supra*, which, as stated above, apparently disposes of the question.

The petitioner contends further that even if preferred stock must be taken into account in determining the applicability of the statutory provisions here involved, the right of the American Gas & Electric Company to redeem the preferred stock of the petitioner at any time gave that company *control* over the preferred stock. But a "control of stock without title, beneficial ownership, or other legal means to enforce it" and resting only upon acquiescence, business necessities, or other considerations of no binding force is not sufficient to meet the requirements of the statute. *Handy & Harman* v. *Burnet*, 284 U. S. 136, *supra; Burnet* v. *J. Rogers*

Flannery & Co., No. 799, October Term, 1931, decided April 18, 1932; *Burnet* v. *Peavy-Wilson Lumber Co.,* No. 537, October Term, 1931, decided April 18, 1932. As pointed out by the court below, the right of the American Gas and Electric Company to redeem did not confer upon that company any legally enforceable control prior to the exercise of that right. The right to redeem is somewhat analogous to an option to buy or an agreement to first offer stock to the majority stockholders. Such rights, without more, are not sufficient to constitute control of the stock within the meaning of the statutes prior to the exercise of the option or right. *Peytona Lumber Co.* v. *Burnet,* 55 F. (2d) 27 (C. C. A. 4th), now pending before this Court on petition for a writ of certiorari, No. 133, October Term, 1932; *Wadhams & Co.* v. *United States,* 67 C. Cls. 235; *Carnie-Goudie Manufacturing Co.,* 18 B. T. A. 893. Moreover, it does not appear from the findings of the Board of Tax Appeals that the American Gas and Electric Company was in a position during the years in question to redeem the outstanding preferred stock.

In the *Howes Bros. Hide* case, *supra,* the outstanding preferred stock was subject to redemption after 90 days' notice. If, in reversing the decision of the Circuit Court of Appeals for the First Circuit in that case, this Court intended to pass upon the question of *control* arising out of the right to redeem the preferred stock, it has disposed of this contention of the petitioner.

We submit that the American Gas and Electric Company did not own or control substantially all of petitioner's stock as required by the statutes.

CONCLUSION

We submit that the principles applicable to this case have been settled by the decisions of this Court and that they were correctly applied by the Circuit Court of Appeals. Except for the question whether the right to redeem preferred stock gives control to the owners of the common stock, which we submit, was settled by *Handy & Harman, supra,* no question presented in this case can arise under any Revenue Act later than that of 1921. The questions presented are, therefore, not of present general importance. The petition should be denied.

Respectfully submitted.

THOMAS D. THACHER,
Solicitor General.
G. A. YOUNGQUIST,
Assistant Attorney General.
JOHN H. MCEVERS,
J. P. JACKSON,
Special Assistants to the Attorney General.
PAUL D. MILLER,
Attorney.

AUGUST, 1932.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 319 (U. S. C., Title 26, Sec. 1067):

> SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corportions and domestic partnerships that were affiliated during the calendar year 1917.
>
> (b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, * * *.
>
> (c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1082:

> SEC. 240. (b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nomi-

nees substantially all the stock of the other or others, * * *.

Article 633 of Treasury Regulations 62, issued under the Revenue Act of 1921, provides:

> *When corporations are affiliated.*—Corporations will be deemed to be affiliated (a) when one domestic corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (b) when substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. The words "substantially all the stock" can not be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95 per cent or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required for any taxable year beginning prior to January 1, 1922, even though the stock ownership is less than 95 per cent. When the stock ownership or control is less than 95 per cent, but in excess of 70 per cent, a full disclosure of the affiliations should be made, showing all pertinent facts, including the stock owned or controlled in each subsidiary or affiliated corporation and the percentage of such stock owned or controlled to the total stock outstanding.

This information will also be required where like conditions exist and the taxpayer elects to file a consolidated return for any taxable period beginning on or after January 1, 1922. Such statement should preferably be made in advance of filing the return, but if a consolidated return is filed subject to the approval of the Commissioner, the required statement should be filed as a part of the return. The words "the same interests" shall be deemed to mean the same individual, partnership, or corporation, or the same individuals, partnerships, or corporations, but when the stock of two or more corporations is owned or controlled by two or more individuals, by two or more partnerships, or by two or more corporations, the corporations will not be held to be affiliated unless the percentage of stock of such corporations held by each individual, each partnership, or each corporation is substantially the same in each of the corporations.

Article 633 of Treasury Regulations 45, issued under the Revenue Act of 1918, is substantially the same as Article 633 of Treasury Regulations 62.

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No. 163

In the Supreme Court of the United States

OCTOBER TERM, 1932

ATLANTIC CITY ELECTRIC COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 19-25) is reported in 15 B. T. A. 1084. The opinion of the Circuit Court of Appeals (R. 34–38) is reported in 57 F. (2d) 186.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 11, 1932. (R. 38.) The petition for a writ of certiorari was filed June 17, 1932, and granted October 10, 1932. (R. 39.) Jurisdic-

tion is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

1. All of petitioner's common stock, constituting 77 per cent of its total outstanding stock, was owned directly by the American Gas and Electric Company. The balance of its stock, being preferred stock with voting rights and redeemable at any time, was owned by outside interests. Were petitioner and the American Gas and Electric Company affiliated corporations during the years 1917, 1918, and 1919, within the meaning of Section 240 (b)(1) of the Revenue Act of 1918, and Section 1331 (b)(1) of the Revenue Act of 1921?

2. Petitioner was a public service corporation operated independently from the American Gas and Electric Company and was neither physically connected nor merged with that company, nor had it received special permission to file consolidated returns. Was it entitled to affiliation for 1917 under the terms of Section 1331 of the Revenue Act of 1921?

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set forth in the Appendix, pp. 22–25, *infra*.

STATEMENT

The findings of fact made by the Board of Tax Appeals (R. 15–19) may be summarized as follows:

During the taxable years 1917, 1918, and 1919, and for many years prior thereto, the American Gas and Electric Company was a holding corporation owning common stock in a number of lighting and power companies. (R. 16.) It had in excess of 3,000 stockholders. (R. 17.)

The petitioner is a public service corporation organized under the laws of New Jersey and engaged in the business of supplying light, heating, and power in and around Atlantic City, New Jersey. During the taxable years in question it had outstanding 12,500 shares of common stock of $100 par value each, all of which were owned by the American Gas and Electric Company, and 3,702 shares of preferred stock, none of which were owned by the American Gas and Electric Company, although from 655 to 761 of such shares were owned by stockholders of the American Gas and Electric Company.[1] The common stock owned by the American Gas and Electric Company constituted about 77 per cent of the total outstanding common and preferred stock of the petitioner. Holders of the preferred stock were entitled to vote and such stock

[1] The stockholders in the American Gas and Electric Company who owned some of the preferred stock in the petitioner must be taken as "outside interests." Obviously their holdings in the two corporations were not "in like proportions." The Board found (R. 17) that "the control and ownership exercised by the American Gas and Electric Company resulted from its absolute ownership of the entire common stock of its subsidiaries and not from control or ownership of preferred stock by its stockholders."

was preferred to the extent of an annual cumulative dividend of 6 per cent and on final liquidation. It was redeemable at any time and had no other interest in dividends above 6 per cent. (R. 16.)

In no instance during the years in question did any holder of preferred stock vote against or object to any action taken at any stockholders' or directors' meeting of the petitioner, nor against any proposition advanced by the American Gas and Electric Company or its representatives, but voted in conformity thereto. Dividends on the preferred stock at the rate in the contract amount of 6 per cent were always paid promptly and there have never been any unpaid cumulative dividends. (R. 17.)

All financial matters and operations of the petitioner were conducted by and carried on through the American Gas and Electric Company and the executive operations of the petitioner were carried on in the office of the American Gas and Electric Company at New York City. (R. 18.)

The respondent determined deficiencies against the petitioner for the taxable years in question on the basis of separate returns and refused to consolidate the returns of petitioner with those of the American Gas and Electric Company. (R. 15.) The Board of Tax Appeals held that the two corporations were affiliated and should file consolidated returns. The Commissioner appealed, and the Circuit Court of Appeals reversed the Board. (R. 38.)

SUMMARY OF ARGUMENT

I. The principal question here presented is whether the American Gas and Electric Company owned or controlled "substantially all the stock" of petitioner. It owned all the common stock, which was 77 per cent of the total outstanding stock. This was not "substantially all." The fact that the outstanding 23 per cent, owned by outside interests, was all preferred stock limited to 6 per cent cumulative dividends furnishes no reason for not considering such stock, since the statute refers to ownership or control of stock and makes no distinction between common and preferred stock. Moreover, the outstanding preferred stock had voting privileges and the Regulations of the Treasury Department (which have received legislative approval) and the cases hold that the statute refers to *voting* stock, whether preferred or common. Nor did the right to redeem the preferred stock give *control* over that stock prior to the exercise of the right. A "control of stock without title, beneficial enjoyment or other legal means to enforce it" and resting only upon acquiescence, business necessities, or other consideration of no binding force is not sufficient to meet the requirements of the statute.

II. Section 1331 (b) of the 1921 Act, affecting the tax involved for 1917, provides that public service corporations which (1) were operated independently, (2) were not physically connected or

merged, and (3) did not receive special permission to make a consolidated return, shall not be entitled to affiliation. Petitioner does not come within this additional proviso of the statute and for this additional reason should be denied affiliation for 1917.

ARGUMENT

I

THE AMERICAN GAS AND ELECTRIC COMPANY DID NOT OWN OR CONTROL SUBSTANTIALLY ALL OF PETITIONER'S STOCK

Section 1331 (b) of the Revenue Act of 1921 (*infra*, p. 22), and Section 240 (b) of the Revenue Act of 1918 (*infra*, p. 23) both provide that before two or more corporations are entitled to affiliation it must appear either (1) that one corporation "owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others," or (2) that "substantially all the stock of two or more corporations is owned or controlled by the same interests." [2]

It is conceded that this case does not involve the second of the above provisions of the statute relat-

[2] The quotations are taken from Section 240 (b) of the Revenue Act of 1918. Section 1331 (b) of the Revenue Act of 1921 (*infra*, p. 22), made applicable to the year 1917, is substantially the same except that subdivision (2) does not contain the word "controlled" and the proviso clause placed certain additional limitations upon affiliation. See *Montgomery Cotton Mills* v. *United States*, 67 C. Cls. 169, 171. This difference in the Acts as affecting the year 1917 will be discussed later, pp. 18–21, *infra*.

ing to ownership or control *by the same interests.* (Pet. 8.) The sole question is whether the American Gas and Electric Company owned directly or controlled substantially all of petitioner's stock.

The American Gas and Electric Company owned directly all of petitioner's common stock, which was only 77 per cent of its total outstanding stock. This was not "substantially all" within the meaning of the statute. In *Handy & Harman* v. *Burnet,* 284 U. S. 136, it was held that 76.66 per cent did not constitute "substantially all" and it has been held that 88 per cent (*Good Mfg. Co.* v. *Burnet,* 58 F. (2d) 685 (App. D. C.)), 85 per cent (*Burnet* v. *Bank of Italy,* 46 F. (2d) 629, 630 (C. C. A. 9th)), certiorari denied, 283 U. S. 846, 77 per cent to 84 per cent (*United States* v. *Cleveland, P. & E. R. Co.,* 42 F. (2d) 413 (C. C. A. 6th)), 83⅓ per cent (*Jos. Denunzio Fruit Co.* v. *Commissioner,* 49 F. (2d) 41 (C. C. A. 6th)), certiorari denied, 284 U. S. 671, and 80 per cent (*Wadhams & Co.* v. *United States,* 67 C. Cls. 235; *Hamilton Carhartt Cotton Mills* v. *Commissioner,* 56 F. (2d) 145 (C. C. A. 5th)), did not constitute "substantially all" of the stock of a corporation.

But the petitioner contends that the American Gas and Electric Company owned all the stock of the petitioner because it owned all the *common* stock of that company, and that the outstanding stock not owned by the American Gas and Electric Company should not be considered since it was all *preferred* stock with no interest in the earnings

above annual dividends of 6 per cent. It is said that because of their limited interest in the corporation the preferred stockholders are more nearly creditors than stockholders. But it is well settled that preferred stockholders are not creditors, but on the contrary are, as the name signifies, owners of corporate capital stock. *Warren* v. *King,* 108 U. S. 389, 398; *Finance & Investment Corporation* v. *Burnet,* 57 F. (2d) 444 (App. D. C.); *Elko Lamoille Power Co.* v. *Commissioner,* 50 F. (2d) 595 (C. C. A. 9th); *Hamlin* v. *Toledo, St. L. & K. C. R. Co.,* 78 Fed. 664 (C. C. A. 6th); *Spencer* v. *Smith,* 201 Fed. 647 (C. C. A. 8th). The statutes here involved refer to ownership or control of *stock* and make no distinction between preferred stock and common stock and if that term is given its ordinary meaning it must be taken to include preferred stock as well as common. Particularly is this true where, as here, the preferred stock has voting privileges (R. 16), showing further that the owners of such stock are not mere creditors, but that as shareholders they own proprietary interests in the business and by their votes may participate in its management.

The applicable regulations of the Treasury Department (Article 633, Regulations 45 and 62; pp. 23–24, *infra*) have construed the statutes as referring not alone to common stock, but to all *voting* stock, whether common or preferred.[3] This inter-

[3] The reason for this interpretation will be discussed later; see pp. 15–16, *infra.*

pretation has received legislative approval in Section 240 (c)(1) of the Revenue Act of 1924, c. 234, 43 Stat. 253, 288 (U. S. C., Title 26, Sec. 993), which section, in reenacting the statutes here involved, provides that two corporations are deemed affiliated "if one corporation owns at least 95 per centum of the *voting* stock of the other, * * *." (Italics ours.) The Report of the Committee on Ways and Means, referring to this provision, states (House Report No. 179, 68th Cong., 1st Sess., p. 24.)

> The requirement that the stock held must be "voting" stock merely embodies in the law the present rule of the Treasury Department.

See also Section 240 (c) and (d) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 46 (U. S. C. App., Title 26, Sec. 993), Section 141 (d) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 831 (U. S. C. Sup. V, Title 26, Sec. 2141), and Section 141 (d) of the Revenue Act of 1932, c 209, 47 Stat. 169, 213. The regulations, having been approved by later clarifying Acts of the legislature and having stood unchanged for many years, have the force and effect of law.

Moreover, the cases hold that the earlier Acts related to *voting* stock. *Schlafly* v. *United States,* 4 F. (2d) 195, 200 (C. C. A. 8th); *Ice Service Co.* v. *Commissioner,* 30 F. (2d) 230 (C. C. A. 2d); *United States* v. *Cleveland, P. & E. R. Co.,* 42 F. (2d) 413 (C. C. A. 6th), *supra;* cf. *Commissioner* v. *City Button Works,* 49 F. (2d) 705 (C. C. A.

2d), certiorari denied, 284 U. S. 670. See also *Appeal of Isse Koch & Co., Inc.*, 1 B. T. A. 624.

In *Howes Bros. Hide Co.* v. *Commissioner*, 49 F. (2d) 878 (C. C. A. 1st), the court held that where the same interests owned directly all the common stock of two corporations, affiliation could not be denied merely because outside interests owned a substantial block of voting preferred stock in one of the corporations. But that decision was reversed by this Court *per curiam* (284 U. S. 583) on the authority of its decision in the *Handy & Harman case*, 284 U. S. 136, *supra*.

The petitioner contends that the reversal by this Court in the *Howes Bros. Hide case* was because the same interests did not hold the stock of the corporations there involved in like proportions—a requisite which is established by the *Handy & Harman* decision, *supra*. It is true that the facts in the *Howes Bros. Hide case* do show that the same interests did not hold the shares of the corporations involved in like proportions, but that point was not discussed by the Circuit Court of Appeals in its opinion nor was it raised in the Government's petition for certiorari. In the *Howes Bros. Hide case*, as said by the Circuit Court of Appeals (49 F. (2d) 878, 880), "The main question is as to the minority holding of first preferred stock in the Howes brothers corporation," and the decision was based on that point. The Government's petition for certiorari dealt chiefly with that question as did likewise the brief in opposition. While the de-

cision in the *Handy & Harman case* did not involve the precise question raised in the *Howes Bros. Hide case* or in this case, we are unwilling to assume, as urged by petitioner, that this Court reversed the *Howes Bros. Hide case* on a point not passed upon by the Circuit Court of Appeals and not raised in the petition for certiorari.

In deciding the questions presented in the *Howes Bros. Hide case* it was pertinent to refer to the *Handy & Harman case,* because it was there held that ownership and control meant *stock* ownership and control, and not ownership or control of the business. It was also decided that control must be a legally enforceable control, as distinguished from any other kind of control. Consequently, we believe that the questions presented in the *Howes Bros. Hide case,* and again presented in this case, have already been determined by this Court.

The only other decision holding that voting preferred stock should not be taken into account in determining the application of the statutory provisions here involved is *Commissioner* v. *Shillito Realty Co.,* 39 F. (2d) 830 (C. C. A. 6th). But, as pointed out in the later decision by the same court in *United States* v. *Cleveland, P. & E. R. Co.,* 42 F. (2d) 413, 419 (C. C. A. 6th), *supra,* that case went off on its own peculiar facts and seems to have turned on the fact that outstanding voting power was controlled by proxies, a fact not presented here. The latter case is in conformity with the decision below and should be taken as modifying, if not

actually overruling, the decision in the *Shillito case*. In any event the *Shillito case* was decided prior to this Court's decision in the *Howes Bros. Hide case, supra,* which, as stated above, apparently disposes of the question.

We submit that the court below correctly held that the American Gas and Electric Company did not own substantially all of petitioner's "stock" within the meaning of the statute as interpreted by the courts and the regulations.

Petitioner's principal argument goes to the intent and purpose of the affiliation statutes. It is contended that since the purpose of the statute, as stated in the *Handy & Harman case, supra,* (p. 140), was "to secure substantial equality as between shareholders who ultimately bear the burden" the statute can not apply to the preferred stockholders here because the burden of intercompany transactions and of the Federal income taxes rests upon the common stockholders alone. There are two answers to this contention. First, the preferred stockholders may bear their share of the burden. It was the purpose of the statute, as the *Handy & Harman case* discloses, to protect a substantial minority who might ultimately bear the burden of another's taxes. Affiliation was required where the same stockholders owned all except a negligible minority of the stock in the common enterprise, in which event no substantial inequality

resulted from consolidation. But where the outstanding minority was substantial, affiliation was not required. Here the preferred stockholdings were substantial and uncontrolled and potentially bore their share of the burden. If the American Gas and Electric Company had decided to throw upon this petitioner the whole burden of paying the consolidated tax levied on its 30 or 40 subsidiaries (R. 17) or even make this petitioner pay part of the excess profits taxes on income earned by these other subsidiaries, it seems evident that the minority preferred stockholders would bear a distinct burden. Such payment might not only serve to rob such stockholders of their immediate right to dividends, but might impair their capital investment as well. The fact that dividends were actually paid in the years involved does not mean that the potential burden referred to did not exist. Petitioner's argument would make affiliation depend upon the varying successes or failures of the corporation rather than upon the statute making stock ownership or control the test.

There is another reason why petitioner's contention is unsound. It was not the sole purpose of affiliation to secure equality among shareholders. That was one purpose but the primary purpose was to prevent tax evasion of the excess-profits taxes levied under the War Revenue Act of 1917, c. 63, 40 Stat. 300, and the Revenue Act of 1918, c. 18, 40 Stat. 1057. That intent is shown from the legis-

lative history of the Act in question [4] and by regulations of the Treasury Department promulgated contemporaneously therewith (Regulations 45, Article 631). The courts have recognized this twofold purpose and have repeatedly held that the primary purpose was to stop tax evasion. *Duke Power Co.* v. *Commissioner,* 44 F. (2d) 543 (C. C. A. 4th), certiorari denied, 282 U. S. 903; *In re Temtor Corn*

[4] Provision for affiliation first appeared in the form of regulations (Articles 77 and 78, Regulations 41) promulgated by the Commissioner under the Revenue Act of 1917, c. 63, 40 Stat. 300. When the revenue bill of 1921 was under consideration the validity of those regulations as affecting 1917 taxes was questioned and for that reason Section 1331 of the Revenue Act of 1921, c. 136, 42 Stat. 227, 319 (*infra*, p. 22), was adopted providing for retroactive validation. See House Report No. 350, 67th Cong., 1st sess., p. 16; Senate Report No. 275, 67th Cong., 1st sess., p. 34.

The excess-profits taxes were continued in the 1918 Revenue Act and that Act provided for affiliation in language practically identical with that of the earlier regulations (Section 240, Revenue Act of 1918, c. 18, 40 Stat. 1057 (*infra*, p. 23)). While the principal purpose of the Act, like that of the earlier regulations, was to prevent tax evasion, a year's experience had revealed that affiliation also benefited the taxpayers. Congress clearly had in mind these two purposes. See Senate Report No. 617, 65th Cong., 3rd sess., pp. 8–9. See also Congressional Record, Vol. 57, Part 1, p. 549. Since the primary purpose was to prevent tax evasion, the filing of consolidated returns was made compulsory. It was not until the excess-profits tax was repealed with the passage of the Revenue Act of 1921, c. 136, 42 Stat. 227, that taxpayers were given the choice of filing separate or consolidated returns. See Senate Report No. 275, 67th Cong., 1st sess., pp. 19–20. *Duke Power Co.* v. *Commissioner*, 44 F. (2d) 543 (C. C. A. 4th), certiorari denied, 282 U. S. 903.

& Fruit Products Co., 299 Fed. 326, 331 (E. D. Mo.), affirmed *sub nom. Schlafly* v. *United States*, 4 F. (2d) 195, 200 (C. C. A. 8th); *United States* v. *Whyel*, 19 F. (2d) 260, 262 (W. D. Pa.); *Pelican Ice Co., Ltd.* v. *Commissioner*, 37 F. (2d) 285, 286 (C. C. A. 5th); *Lavenstein Corporation* v. *Commissioner*, 25 F. (2d) 375, 376 (C. C. A. 4th); *Peavy-Wilson Lumber Co.* v. *Commissioner*, 51 F. (2d) 163, 167 (C. C. A. 5th), reversed without opinion and apparently on another point, 286 U. S. 524. See also *Appeal of Isse Koch & Co., Inc.*, 1 B. T. A. 624.

In the light of this primary purpose to prevent tax evasion, it seems clear that the preferred stockholders must be considered. Congress evidently had in mind that an outstanding substantial minority interest would, as a practical matter prevent the transfer of profits from one company to another for the purpose of evading taxes. It was probably realized that manipulation jeopardizing the interest of the minority would not be attempted and if attempted would be enjoined in equity. Consequently where the adverse interest was substantial affiliation was not required. It was only when the outstanding interests were negligible that affiliation was deemed necessary. Certainly, in this case if the American Gas and Electric Company, for purposes of its own, had decided through price fixing, charges for services, or other means to deprive the petitioner of its income and to as-

sign this income arbitrarily to another of its less prosperous subsidiaries, it seems evident that the preferred stockholders, although in a minority, would have objected strenuously to such manipulation and could and would have effectively blocked such attempts.

Since this check by the substantial minority might not, in many cases, be effective unless that minority had voting power and a voice in the management, the Treasury Department has construed the statute as referring only to *voting* stock. As pointed out above, this interpretation has been sanctioned by the courts and has received legislative approval in subsequent Acts and should be given the force and effect of law. If it be said that the Treasury Department was wrong in so interpreting the statute, the word "stock" must then be given its general meaning and be taken to include all preferred stock as well as common stock.

We submit that considering the twofold purpose of the 1918 Act the preferred-stock holdings here involved must be considered; and since they must be considered, it follows that the American Gas and Electric Company did not own substantially all of petitioner's stock.

Since the American Gas and Electric Company did not own directly substantially all of petitioner's stock there remains the question of whether it controlled any stock it did not own. Petitioner contends that even if preferred stock must be taken into account the right of the American Gas and

Electric Company to redeem the preferred stock of the petitioner at any time gave that company *control* over the preferred stock. But a "control of stock without title, beneficial ownership, or other legal means to enforce it" and resting only upon acquiescence, business necessities, or other considerations of no binding force is not sufficient to meet the requirements of the statute. *Handy & Harman* v. *Burnet,* 284 U. S. 136, *supra; Burnet* v. *J. Rogers Flannery & Co.,* 286 U. S. 524; *Burnet* v. *Peavy-Wilson Lumber Co.,* 286 U. S. 524. As pointed out by the court below, the right of the American Gas and Electric Company to redeem did not confer upon that company any legally enforceable control prior to the exercise of that right. The right to redeem is somewhat analogous to an option to buy or an agreement to first offer stock to the majority stockholders. Such rights, without more, are not sufficient to constitute control of the stock within the meaning of the statutes prior to the exercise of the option or right. *Peytona Lumber Co.* v. *Burnet,* 55 F. (2d) 27 (C. C. A. 4th), certiorari denied, October 10, 1932, No. 133, October Term, 1932; *Wadhams & Co.* v. *United States,* 67 C. Cls. 235; *Madera Yosemite Big Tree Auto Co.* v. *United States,* 49 F. (2d) 672, 678 (C. Cls.); *Carnie-Goudie Manufacturing Co.,* 18 B. T. A. 893. Moreover, it does not appear from the findings of the Board of Tax Appeals that the American Gas and Electric Company was in a position during the

years in question to redeem the outstanding preferred stock.

In the *Howes Bros. Hide case, supra,* the outstanding preferred stock was subject to redemption after 90 days' notice. If, in reversing the decision of the Circuit Court of Appeals for the First Circuit in that case, this Court intended to pass upon the question of *control* arising out of the right to redeem the preferred stock, it has disposed of this contention of the petitioner.

We submit that the American Gas and Electric Company did not own or control substantially all of petitioner's stock as required by the statutes.

II

PETITIONER, BEING A PUBLIC SERVICE CORPORATION, MUST FILE SEPARATE RETURNS FOR THE YEAR 1917

There are two statutes involved in this case, Section 240 of the Revenue Act of 1918 (*infra* p. 23) and Section 1331 of the Revenue Act of 1921 (*infra,* p. 22) which retroactively amended the Revenue Act of 1917. The first of these statutes applies to the 1918 and 1919 taxes in this case and the second applies only to the 1917 tax. The foregoing argument applies equally to all three years since the provisions of both statutes pertinent to the discussion are identical. However, Section 1331 contains a proviso which, we submit, furnishes an additional reason for denying petitioner the right to affiliation for the year 1917. Section 1331, *infra,* provides:

> For the purposes of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged, and (3) did not receive special permission to make a consolidated return shall not be construed to have been affiliated; * * *[5]

It is manifest from the record that petitioner was a public-service corporation (R. 16), operated independently as a separate and distinct corporation from the American Gas and Electric Company, with which it seeks to affiliate. It was organized and operated in a different State under a different State law. (R. 16.) Each had its own corporate existence with its own corporate structure, separate and apart from each other.

Not only was the petitioner operated independently as a distinct entity, but from the record it was not physically connected with the American Gas and Electric Company. That company was a New York corporation with offices in New York City (R. 10), while the Atlantic City Electric Company was a New Jersey corporation operating in and around Atlantic City, New Jersey (R. 16).

Moreover, from the whole record it is clear that the petitioner here had not actually merged with the American Gas and Electric Company. That

[5] This provision was prompted by the improbility of tax evasion by public utilities through manipulation of accounts, due to their regulation by public service commissions. See *Union Pacific Railroad Co.* v. *Commissioner*, 17 B. T. A. 793.

company was a holding company. (R. 16–17.) There was no merger.

Furthermore, petitioner never received special permission to make consolidated returns as required by the statute. The very fact that the deficiency in these cases arises out of the refusal on the part of the Commissioner to permit affiliation and the fact that the deficiency is determined on the basis of a separate return (R. 15) shows that this requirement of the statute has not been met.

Since petitioner was operated independently from the holding company and since it was neither physically connected nor merged with that company, and since special permission could not have been obtained to file consolidated returns, it follows that petitioner is not entitled to affiliation for 1917.

It may be argued that the proviso referred to applies only to cases where two or more public service corporations seek affiliation with each other and does not apply where a public service corporation seeks affiliation with a holding corporation. But the record shows that in this same case the Scranton Electric Company, another public service corporation, is likewise seeking affiliation with the American Gas and Electric Company. (R. 15.)[6] To per-

[6] The *Scranton case* and this case were tried together before the Board on one record. In the Circuit Court of Appeals it was stipulated that only the record in this case should be printed and that the decision here should control the *Scranton case*. The time for filing a petition for certiorari in the *Scranton case* has been extended to December 11, 1932.

mit the two public service corporations to affiliate with one holding company and thereby become affiliated with each other would be permitting by indirection that which the statute directly prohibits.

We submit, for this additional reason, the petitioner must file separate returns for the year 1917.

CONCLUSION

The decision of the court below should be affirmed.

Respectfully submitted,

THOMAS D. THACHER,
Solicitor General.
G. A. YOUNGQUIST,
CHARLES B. RUGG,
Assistant Attorneys General.
SEWALL KEY,
J. P. JACKSON,
Special Assistants to the Attorney General.
ERWIN N. GRISWOLD,
Attorney.

NOVEMBER, 1932.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 319 (U. S. C., Title 26, Sec. 1067):

> SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.
>
> (b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided,* That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. For the purposes

of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged and (3) did not receive special permission to make a consolidated return, shall not be construed to have been affiliated; but a railroad or other public utility which was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated, return shall be construed to have been affiliated.

(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1082:

SEC. 240. (b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

Treasury Regulations 45, issued under the Revenue Act of 1918, provide:

ART. 631. *Affiliated corporations.*—The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is

owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and net income of the branch form a part of the invested capital and net income of the entire organization. Where such branches or units of a business are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group. See articles 785, 791, 802, and 864–869.

ART. 633. *When corporations are affiliated.*—Corporations will be deemed to be affiliated (a) when one domestic corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (b) when substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. The words "substantially all the stock" can not be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95 per cent or more of

the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required even though the stock ownership is less than 95 per cent. When the stock ownership or control is less than 95 per cent, but in excess of 50 per cent, a full disclosure of affiliations should be made, showing all pertinent facts, including the stock owned or controlled in each subsidiary or affiliated corporation and the percentage of such stock owned or controlled to the total stock outstanding. Such statement should preferably be made in advance of filing the return, with a request for instructions as to whether a consolidated return should be made. In any event such a statement should be filed as a part of the return. The words "the same interests" shall be deemed to mean the same individual or partnership or the same individuals or partnerships, but when the stock of two or more corporations is owned or controlled by two or more individuals or by two or more partnerships a consolidated return is not required unless the percentage of stock held by each individual or each partnership is substantially the same in each of the affiliated corporations.

Article 633 of Treasury Regulations 62, issued under the Revenue Act of 1921, is substantially the same as Article 633 of Treasury Regulations 45.

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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1932.

No. 163.

ATLANTIC CITY ELECTRIC COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REHEARING.

GRAHAM SUMNER,
COURTLAND KELSEY,
Counsel for Petitioner.

IN THE

Supreme Court of the United States

OCTOBER TERM—1932, No. 163.

ATLANTIC CITY ELECTRIC COMPANY,
Petitioner,

AGAINST

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REHEARING.

Comes now the above-named petitioner Atlantic City Electric Company, and presents this, its petition for a rehearing herein, upon the following grounds:

1. It is stated in the opinion that the purpose of Congress in providing for consolidated returns in the Revenue Acts for 1917 and 1918 was "to secure substantial equality among stockholders who ultimately bear the burden of taxation and to prevent evasion through the manipulation of intercompany transactions". It is submitted that the denial of consolidation in this case tends to defeat rather than to accomplish this purpose of Congress.

The record shows conclusively that the dividends payable upon the preferred stock of the petitioner were earned more than seven times over and that the holders of this stock bore no part of the burden of taxation, that the American Gas and Electric Company, as the holder of all the common stock, was entitled to all the earnings of the petitioner in excess of dividends upon the preferred stock and had absolute power to elect the entire Board of Directors of the petitioner and to control all the details of its management, and that the existence of the preferred stock was not a check against, and could not be expected to prevent, evasion of taxes through intercompany transactions.

If it is held that this preferred stock bears some part of the burden of taxation and that the existence thereof prevents evasion of taxes through intercompany transactions, it is not possible to conceive of any class of stock which would not bear some part of such burden or would not prevent such evasion of taxes.

2. The question whether the holders of the outstanding stock of a subsidiary corporation have the right to vote has no bearing upon the question whether such stock bears any part of the burden of taxation or is a check against evasion of taxes through intercompany transactions. If the parent corporation holds a majority of the voting stock and the power to elect the entire Board of Directors, the voting right of the holders of the minority stock has no effect upon the management. The standing of a holder of voting stock to maintain an action to enjoin or set aside an improper transaction is no better than that of a holder of non-voting stock.

3. It is true that the provisions of the Revenue Acts for 1917 and 1918, with reference to consolidated returns, made no distinction between preferred stock and common stock. It is equally true that these acts made no distinction between voting stock and non-voting stock, or between any other classes of stock. We submit that there is a logical ground for

distinguishing between classes of stock upon the basis of proprietary rights, but no logical ground for distinguishing between them upon the basis of voting rights. It would be logical to exclude a preferred stock which had a limited interest in dividends, bore no part of the burden of taxation and had no substantial interest in intercompany transactions, even though it had the voting right, but not logical to exclude a common stock which had an unlimited interest in dividends, bore a proportionate share of the burden of taxation and had a direct interest in every intercompany transaction, even though it had no voting right. Common stocks of this character are the B stocks of the tobacco companies, whose rights are the same as those of the regular common stocks except that they do not include the voting right.

4. The provisions of the Revenue Acts for 1924 and subsequent years with reference to consolidated returns are purely prospective. They apply only to the years 1924 and subsequent thereto. These provisions definitely purport not to be retroactive. It is accordingly submitted that these later acts cannot be held to change or in any way affect the provisions for consolidation contained in the acts for 1917 and 1918. The fact that Congress inserted the word "voting" in these later acts cannot logically give rise to the inference that Congress intended to insert the word "voting" in the earlier acts.

5. Article 633 of Treasury Regulations 45 and 62 uses the word "stock" no less than twelve times. In only one of these cases is the word "voting" used. This is the case where it is stated that the owning or controlling of 95% of the voting stock will be deemed to constitute an affiliation. The following provisions, however, indicate definitely that the owning or controlling of 95% of the voting stock is not essential to constitute an affiliation and that in some cases the owning or controlling of substantially less than 77% of the voting

stock would be sufficient to constitute an affiliation. The fundamental and controlling provision of this Article is the provision that "the words substantially all the stock cannot be interpreted as meaning any particular percentage but must be construed according to the facts of the particular case". This Article was the rule of the Treasury Department prior to 1924 and the Revenue Act of 1924 was not a reenactment of the prior acts as interpreted by the Treasury Department.

6. The petitioner contended both in its brief and on the oral argument that the power of the American Gas and Electric Company to redeem the preferred stock of the petitioner carried control over that stock and that accordingly the American Gas and Electric Company owned or controlled all the stock of the petitioner. This contention is made irrespective of the other contention that the common stock was substantially all the stock of the petitioner within the meaning of the Revenue Acts. It is recognized in the opinion that control of stock without legal title or beneficial ownership may satisfy the statute if the control is legally enforcible and not dependent solely upon acquiescence or business considerations. There is no doubt that the power of the American Gas and Electric Company to redeem the preferred stock of the petitioner had binding force and was legally enforcible. It was conferred by the charter of the petitioner upon the holders of its common stock. It was not in any way dependent upon acquiescence or business considerations. It gave the American Gas and Electric Company the legal power to take the stock away from its owners at any time and extinguish it. It is hard to imagine how any one person could have any more effective control over stock unless he had the legal title or beneficial ownership. The word "control" as used in the Acts must mean something less than complete control over disposition and voting. No person could have such complete control unless he had the legal title or beneficial ownership.

The voting right is not separable from the legal title. In the case of a voting trust, the voting trustees hold the legal title.

Wherefore, on the foregoing grounds, this petitioner respectfully prays this Honorable Court to grant a rehearing of this cause.

GRAHAM SUMNER,
COURTLAND KELSEY,
Counsel for Petitioner.

CERTIFICATE OF COUNSEL.

I, Graham Sumner, of counsel for the petitioner herein, hereby certify that the foregoing petition for a rehearing is presented in good faith and not interposed for delay.

GRAHAM SUMNER.

SUPREME COURT OF THE UNITED STATES.

No. 163.—October Term, 1932.

Atlantic City Electric Company, Petitioner, *vs.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[February 6, 1933.]

Mr. Chief Justice Hughes delivered the opinion of the Court.

The question presented is whether the petitioner, Atlantic City Electric Company, was affiliated with the American Gas and Electric Company so that the federal taxes for 1917, 1918, and 1919 should be determined upon the basis of consolidated returns under Section 1331 of the Revenue Act of 1921 (42 Stat. 319), as applicable to the year 1917, and Section 240 of the Revenue Act of 1918 (40 Stat. 1081, 1082). The Circuit Court of Appeals, reversing the order of the Board of Tax Appeals (15 B. T. A. 1084), upheld the ruling of the Commissioner that the corporations were not affiliated and must make separate returns. 57 F. (2d) 186. The case comes here on certiorari, 287 U. S. —.

The following facts were found by the Board of Tax Appeals: The petitioner, Atlantic City Electric Company, is a public service corporation. During the years in question, it had outstanding 12,500 shares of common stock, of the par value of $100 per share, and 3702 shares of preferred stock. Holders of preferred stock were entitled to vote and that stock was preferred to the extent of an annual cumulative dividend of six per cent and on final liquidation. The preferred stock was redeemable at any time and had no interest in dividends except as above stated. The American Gas and Electric Company was a holding company. It owned all the common stock of the Atlantic City Electric Company and none of its preferred stock. 655 to 761 shares of that preferred stock were owned by stockholders of the American Gas and Electric Company, but the finding is that the control exercised by that Company resulted "from its absolute ownership of the en-

tire common stock of its subsidiaries and not from control or ownership of preferred stock by its stockholders". Of the total outstanding stock of the Atlantic City Electric Company, preferred and common, the American Gas and Electric Company owned approximately 77 per cent.

With respect to control of stock, as creating the affiliation which affords a basis for a consolidated return, Section 1331 of the Revenue Act of 1921 is to the same effect as Section 240 of the Revenue Act of 1918. The requirement of control, in the absence of legal title or beneficial ownership, is not satisfied by acquiescence or by business considerations without binding force. There must be a control that is legally enforceable. *Handy & Harman* v. *Burnet*, 284 U. S. 136, 140, 141. And it must be control of "substantially all the stock". In *Handy & Harman* v. *Burnet, supra*, legally enforceable control of somewhat more than 75 per cent of the stock was held to be insufficient. The question, then, is whether in the instant case the entire voting stock, preferred and common, should be considered in determining whether there was affiliation, or the common stock alone.

The purpose of the Congress was to secure substantial equality among stockholders who ultimately bear the burden of taxation and to prevent evasion through the manipulation of intercompany transactions. *Handy & Harman* v. *Burnet, supra.* See, also, *Burnet* v. *Aluminum Goods Mfg. Co.*, decided January 9, 1933. The requirement of consolidated returns was "based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation". Treasury Regulations No. 45, Art. 631.[1] In establishing ownership or

[1]Article 631 of Regulations No. 45 is as follows:

"*Affiliated corporations.*—The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and net income of the branch form a part of the invested capital and net income of the entire organization. Where such branches or units of a busi-

control of substantially all the stock as the criterion of a business unit, the statute made no distinction between preferred and common stock. It referred simply to "stock" and we perceive no ground upon which stock with voting right can be treated as excepted. The Treasury Regulations under the Revenue Act of 1918 regarded the statutory requirement as relating to the "outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year". Regulations No. 45, Art. 633. The same construction was given by the Department to the corresponding provision of the Revenue Act of 1921. Regulations No. 62, Art. 633. The Congress, in the Revenue Act of 1924, embodied this construction in the statute itself.[2] Sec. 240 (c) (1), 43 Stat. 288. See, also, Revenue Act of 1926, sec. 240 (c) (d), 44 Stat. 46; Revenue Act of 1928, sec. 141 (d), 45 Stat. 831; Revenue Act of 1932, sec. 141 (d), 47 Stat. 213. Compare *Schlafly* v. *United States*, 4 F. (2d) 195, 200; *Ice Service Co.* v. *Commissioner*, 30 F. (2d) 230, 231; *United States* v. *Cleveland, P. & E. R. Co.*, 42 F. (2d) 413; *Commissioner* v. *City Button Works*, 49 F. (2d) 705.

Nor are we able to conclude that in the instant case the preferred stock with voting right should be excluded because it was redeemable at any time and had a limited interest in dividends. Compare *Commissioner* v. *Shillito Realty Co.*, 39 F. (2d) 830; *United States* v. *Cleveland, P. & E. R. Co.*, 42 F. (2d) 413. Despite redeemability and the limitation of dividends, the owners of the preferred stock were not in the position of creditors, but were

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ness are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group".

[2]With respect to this provision, the report of the Committee on Ways and Means of the House of Representatives said: "The requirement that the stock held must be 'voting' stock merely embodies in the law the present rule of the Treasury Department". House Rep. No. 179, 68th Cong., 1st sess., p. 24.

stockholders with a proprietary interest in the corporate undertaking and with a corresponding relation, through the voting right, to the direction of that undertaking. The voting right remained unimpaired until actual redemption. The statute is not concerned with a failure to exercise existing rights, but with what is deemed to be a more certain and adequate test of a unitary enterprise. According to this test, petitioner failed to show affiliation. *Burnet* v. *Howes Brothers Hide Co.*, 284 U. S. 583, 584.

Judgment affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.